ACCESS TO CREDIT IN THE ALTERNATIVE CONSUMER CREDIT MARKET

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Executive Summary

This paper examines the growth of consumer vulnerability in relation to credit markets and the growth of the alternative financial sector. It evaluates the existing legal framework and suggests some directions for future research and policymaking.

I. The growth of consumer vulnerability

The concept of vulnerability includes those consumers who are more likely to pay a very high price for credit, and those excluded from mainstream credit or from access to financial services. Social groups who are more likely to fall within this category include those on low incomes or in financial distress (recent bankruptcy or bad credit). Certain groups such as single parent mothers, unattached elderly persons and unattached individuals under 25 have a much higher likelihood of experiencing low income. There is also overlap between low income and certain groups protected under Human Rights Codes, such as single parent mothers, and young unattached individuals. Recent immigrants and some visible minority groups may also be disadvantaged and encounter discrimination.

There are also broader socio-economic factors which are relevant to understanding the growth of the alternative financial sector. During the past twenty five years there has been a growth in income inequality, declining savings to income ratios, and increasing debt-to- income ratios (now at 100%). There are four times as many consumer bankruptcies in 1998 as in the mid 1980s. Significant numbers of consumers may be using credit to maintain living standards in the face of flat incomes. There is thus a larger group of individuals who may have problems with credit, perhaps caused by changes in circumstance such as marital breakdown or unstable employment and who may face difficulties in funding short term credit needs in the mainstream market.

II. The Alternative Financial Sector

Writers in the US have described the growth over the past two decades of an alternative financial sector which includes "fringe banking" and "sub-prime lending". These terms refer to a variety of financial services and credit selling which target the bottom third of the economic ladder and/or individuals with spotty or blemished credit histories. Examples of these services include cheque- cashing, payday loans, pawnbrokers and second-hand dealers, rent-to-own stores, tax- rebate discounting, loan- broking, credit repair companies, and sub- prime automobile and mortgage lending. There is increasing consolidation in some of these industries with the growth of cheque cashing and pawnbroker chains. It would be mistaken to view this industry as a monolith or all consumers of its products as drawn from the same social background. However, the description of an alternative financial sector does provide a useful framework to focus on trends and issues in credit granting in this area.

Executive Summary, continued

Part II of the paper provides a thumbnail sketch of the growth of this sector and outlines the demographics of the users of the industry and why they use these high cost institutions.

Some highlights:

- There are higher numbers of cheque cashing stores in British Columbia, Ontario and Alberta than would be expected based on the provincial percentages of the national population. In contrast Quebec has a smaller per capita cheque cashing industry
- Payday loans appear to be common in many provinces. They are generally made for up to 14 days and their costs range from about $15-$25 for a $100 loan. When these costs are stated as an APR they range between 390% and 650% .
- Pawnbrokers are increasing in number in several provinces.
- The largest rent-to-own store in Canada has grown from revenues of $442,000 in 1992 to $56 million in 1997 and serves approximately 75,000 consumers
- There were 639,241tax refunds discounted in 1997 with an average payment of $821.79.
- Finance companies serve 1.74 million consumers, providing financial services to those groups who are underserved by banks, trust companies and credit unions, those entering the credit market and those who want to obtain small amounts of credit
- There appears to be the emergence of sub-prime auto lending which may involve a form of automobile pawn.

Characteristics of users:

- Cheque cashing: Eighty percent with annual incomes under $30000 (1995) and 75% under the age of 35. Sixty-five percent have bank accounts. Many consumers may be unskilled workers or independent contractors.
- Rent-to-own: "bottom third of economic ladder"; "individuals without access to credit and who lack savings"; "people with short term needs"; "individuals desiring flexibility of payment"
- Tax rebate discounting: vast majority with incomes less than $20,000 (1995); sixty four percent under 34, most single. More men than women discount in every income bracket except between $10,000-$19,999.
- Loan brokers: individuals on low incomes, in dire financial straits or who, because of a bad credit record, unable to obtain credit elsewhere.
- Finance companies: those underserved by banks, credit unions and trust companies.

Further characteristics:

- increasing consolidation with a number of national chains combined with small operators
- uneven regulation. Some industries are not regulated directly (cheque cashing, payday loans), others avoid aspects of existing credit regulation (rent-to-own), while others are regulated both provincially and Federally (tax rebate discounting).

Concerns that have been raised:

- Consumers pay much higher prices for goods and services in this sector than in mainstream markets. The rates charged for payday loans violate the criminal interest provisions of the Criminal Code.
- Consumer groups in the US argue that some of the players in these industries engage in deceptive marketing and oppressive collection tactics
- transactions are structured (e.g. rent to own) to avoid consumer protection measures which apply to traditional forms of credit granting

Why do individuals use these institutions? Four potential reasons.

- Individuals have no reasonable choice because they do not have access to the mainstream financial sector. This may be a temporary or continuing situation for the consumer
- Individuals choose to deal with these institutions because they offer advantages over the mainstream financial sector. These might include convenience, the absence of the need to fear a denial of credit and the ability to access goods or money immediately.
- Individuals may continue to use these forms of credit out of habit even though they may be eligible for lower cost credit elsewhere. Lenders may cultivate relationships with consumers to discourage them from seeking credit elsewhere.
- Market irrationality. Lower income consumers may use these institutions because of an inability to make rational choices or because of individual inadequacies.

I conclude that the first three explanations are relevant to use of the alternative financial sector. There is little evidence that lower income consumers differ systematically from middle income consumers in levels of market rationality. These conclusions suggest that a multifaceted approach is appropriate to the issues associated with the alternative financial sector.

III Policy Framework: Rationales and Explanations for Regulation

There are three traditional rationales for the regulation of consumer markets: market failure, distributive justice (including ideas of risk and loss spreading) and paternalism. A continuing theme in consumer protection has been the protection of the disadvantaged although there is controversy as to how effective consumer protection measures are in achieving this goal.

There are standard economic rationales for regulation of the alternative financial sector. These include the possibility of local monopoly power where consumers face barriers (such as high transportation costs) to searching for alternative services.

1. Information Failure and Bounded Rationality

A central rationale for credit regulation is that of information failure and it is argued that there may be less reliable information in lower income markets, less provision by neutral third parties of accurate information, and less monitoring of information in these markets by government. This may lead to greater potential for fraud and deception as well as non-disclosure of relevant information. There may also be private law failures in assuring market performance given the small economic losses and the difficulties which more vulnerable consumers may have in enforcing their rights.

There are also important aspects of bounded rationality which are relevant to several forms of fringe banking such as cheque cashing, payday loans, tax rebate discounting and rent-to-own. Bounded rationality, which is discussed in a large body of psychological and economic literature, suggests that individuals deviate significantly from the economic model of rational decision making in making intertemporal decisions.

One finding of particular relevance to payday loans is that individuals may be willing to pay extraordinarily high discount rates in certain situations. Individuals pay a small amount of money in absolute term to obtain an immediate reward (cash, goods) in a short period of time, notwithstanding that the interest rate on this transaction is extraordinarily high. Businesses may exploit this bounded rationality and it has been argued by some scholars that there may be a new market failure of market manipulation. The problem of fringe banking is not a problem of the failings of lower income consumers but rather a more general limitation in consumer decision making. There is also evidence that consumers attempt to protect themselves against this bounded rationality by "hands tying" techniques (automatic deductions to savings plans etc.) and there may be a role for consumer protection in supplying some "hands-tying" mechanisms.

The literature on bounded rationality suggests that it is important to think more carefully about the type and form of disclosure legislation as a form of consumer protection.

2. Distributive Justice

There are three aspects here: fairness and equal treatment, financial exclusion and consumer protection as positive welfare. Many individuals would view the higher prices paid by vulnerable consumers, particularly for necessities, as a regressive form of taxation. There may also be disquiet concerning the development of a "two-tier" retailing and financial sector. Consumer law may have a role in influencing industry and business norms concerning the concept of fairness in the marketplace.

There is controversy over the role of consumer protection in attempting to ensure that individuals in lower income markets do not pay more than more affluent consumers. Traditional neo-classical economic analysis envisages little role for consumer protection as a form of redistribution and is critical of measures such as interest rate ceilings. This position has been criticised and, while it is accepted that it is important to weigh carefully the economic consequences of consumer protection rules, it is clear that goals such equality of treatment, fairness and redistribution of rights and resources are valid objectives of consumer regulation. It is also important to recognize that consumer detriment for a person on low income is comparatively higher than middle income consumers, since this detriment constitutes a larger percentage of their household income.

The concept of "social exclusion" has become of concern in recent years. In relation to vulnerable consumers there is a concern that financial exclusion may result in creating significant barriers to individuals fully participating in economic and social life.

Writers on the welfare state have suggested that we should rethink this concept in terms of a model of "positive welfare". This recognizes that welfare policy must combine a mix of approaches which are not merely reactive but include educational, regulatory and material components. This concept is highly relevant to the protection of vulnerable consumers where there is a need for policies which combine these three aspects.

3. Explanations of regulation and the protection of the vulnerable consumer

It has been hypothesised that consumer protection may have benefited middle class consumers more than vulnerable consumers and that more social resources are allocated to police markets such as the securities market than are allocated to the protection of lower income financial and credit markets. While this hypothesis has not been tested in Canada there must be a concern that, given cutbacks in allocations to provincial consumer protection responsibilities, and the relatively low visibility of the alternative financial sector, as measured by media coverage, these issues will not be high on the public policy agenda, nor will there be monitoring of enforcement of regulation by external constituencies.

In the US, consumer groups argue that some players in the alternative financial sector are politically influential and have succeeded in obtaining state legislation which is favourable to the development of their industry.

IV. Assessment of existing legal framework of regulation

The common law and private actions have contributed little to the regulation of the alternative financial sector. The existence of the possibility of class actions may however result in an increase in the role of private groups in challenging illegal practices. There is currently a challenge to rent- to- own practices by Options consommateurs and the decision of the Supreme Court of Canada in *Garland v. Consumers Gas* indicates the potential for class actions under section 347 (Criminal Interest Rate) of the Criminal Code.

- Trade practices Acts are potentially a source of regulation of various aspects of deceptive and unfair practices although there is provincial variation in the coverage of these Acts.
- Certain practices such as payday loans and cheque cashing are not directly regulated and aspects of rent-to-own contracts escape regulatory control (e.g. controls on repossession) applicable to similar forms of financing.
- A common aspect of the alternative financial sector is to attempt to structure and restructure transactions to avoid regulation.
- Open textured standards such as "unconscionable" or "unreasonable" are unlikely to have a great impact on the general run of transactions.
- Section 347 of the Criminal Code does not appear to be consistently and actively enforced in relation to payday loans or pawnbrokers.

V Expanding Choices

There are several initiatives and institutional developments which might reduce the need to rely on high-priced credit and counter the existence of financial exclusion.

- Lifeline banking may increase access to the financial mainstream. However, it is unlikely to be a panacea and careful attention is necessary to its manner of implementation. There should be greater experimentation with permitting institutions such as local supermarkets to act as bank agents or depositary institutions.
- Credit unions might attempt to become more attractive to younger consumers. Current requirements of membership shares of $50-75 may act as a barrier to access. The Caisses Populaires appear to be less exclusionary than other financial institutions and provide a full range of financial services to consumers.
- Direct deposit of government transfers will create incentives for easily available forms of identification for opening accounts.
- Community Institutions may play an important role in providing information to communities on financial services and sensitising financial institutions to the problems faced by lower income consumers.
- There should be greater analysis of the different models of community banking and community investment including a survey of the US experience
- Public agencies might provide short term loans at no interest for necessities. This could build on the model of the rent bank which provides one time rental assistance to cover a short term arrears problem.
- The increased interest in counselling in areas such as bankruptcy suggest that some thought should be given to its role in countering financial exclusion and high priced credit.

VI. Conclusion and Recommendations

The institutions considered in this paper have both benefits and costs for consumers. The benefits are that they may meet the needs of certain groups of consumers for short-term loans and extend the availability of credit to individuals who might not have received credit from the mainstream financial sector. There are however costs. These include the payment of a high initial price for these services, the danger of subsequent costly "rollovers " or refinancings, and the possibility of being subject to onerous collection and repossession practices. Some consumers may be subject to deceptive and fraudulent selling practices . Since consumers who use these services are drawn primarily from lower income groups, the consumer detriment which they suffer may be significant, even if the amounts at stake may not appear large to more affluent consumers. Where the alternative financial sector is being used to purchase the necessities of life this detriment may be conceptualised as similar to a regressive form of taxation. It is ironic that publicly quoted companies engaged in sub-prime lending in the US are very profitable investments so that those who invest in the stock market (generally more affluent individuals) profit from the high prices charged to lower income consumers. The world of the alternative financial sector is no longer solely that of the small operators described by David Caplovitz in *The Poor Pay More,* but the public policy challenges remains the same: to attempt to ensure that the needs of vulnerable consumers are met in a less costly manner, to regulate abusive practices effectively, and to ensure that individuals in the alternative financial sector receive a similar level of consumer protection to middle income consumers.

1. Issues for further research

- There have been few detailed studies of the users of the alternative financial sector and their experiences with this sector. Such studies would be useful for identifying more sharply the users of these services, their reasons for use, problems which they encounter, and whether the different institutions described in this paper (rent-to-own, payday loans, pawnbrokers, finance companies) have a common customer base or whether they are serving differing market segments There is a need for both qualitative and quantitative data. Research might focus on two or three urban neighborhoods to test the arguments, first put forward by Caplovitz, concerning local monopolies based on a lack of willingness by consumers to shop outside the neighborhood and so on. Anecdotal information provided to me suggest that the conditions identified by Caplovitz exist in certain Toronto neighborhoods.

- The Federal Trade Commission is currently studying the users of the rent-to-own industry and it would be relatively straightforward to replicate this study in Canada.

- Research is necessary because of the generally low visibility of lower income consumer issues and the fact that consumer complaints to governments, which are often used as a basis for establishing policy priorities, are likely to understate lower income problems. There should also be a study of rural consumers to find out the extent to which the alternative financial sector is a significant aspect of rural living.

- The alternative financial sector and sub-prime lending appear to accept higher write-offs as a cost of operating a profitable industry. Collections and repossessions are therefore an integral part of businesses such as rent-to-own, sub-prime lending and payday loans. As this business expands there is a case for review of existing controls on collections and repossessions. The topic of collections and repossessions was a theme in my discussions with officials and it was not possible within the constraints of this project to obtain systematic and reliable data on collections and repossesssion practices. It would be useful to collect some reliable data on this issue and to review the legislative framework in this area.

- There appears to be the rise of an alternative credit reporting system for the alternative financial sector. For example Tele-Track advertises as the "central source of information on sub-prime consumers in America....providing the missing pieces of the puzzle when evaluating any B, C or D applicant". One finding is that individuals may be using high priced credit although they qualify for mainstream credit. It should be possible for consumers to use a positive experience with the alternative sector as a method of improving their credit rating and investigation of the role of credit granting agencies in facilitating this should be undertaken.

- It would be useful to have more systematic analysis of sub-prime mortgage lending. The potential for consumer harm in this industry is high since, if a consumer defaults, she may lose her only major asset. Moreover, there is evidence that elderly consumers may be targeted by abusive sellers in this market.

- There should be empirical analysis of the effectiveness of the role of licensing as an mechanism for protecting vulnerable consumers. Licensing can be a valuable method of providing public information on the development of an industry and systematic public information is crucial to effective regulation and to permit external monitoring and intelligent debate.

2. Legislative Framework

There is the need for a multifaceted approach to the issues raised by the growth of the alternative financial sector. These include educational and institutional experimentation as well as regulation.

There are some general points of relevance to regulation of credit markets which serve vulnerable consumers.

- Lower income consumers should receive at least the same level of protection as that provided to more affluent consumers of credit and financial services. This includes levels of enforcement as well as legislative rules.
- There is a strong case for detailed rules rather than general standards (such as reasonableness) in the regulation of the alternative financial sector. Bright- line rules reduce enforcement costs and provide certainty to suppliers and consumers.
- There should be greater use of automatic sanctions such as non-enforceability of agreements as a method of ensuring compliance. Private remedies, other than class actions, are of modest impact as a method of ensuring compliance.
- A common characteristic of practices in this sector is the restructuring of transactions to avoid regulation. Legislation should attempt to regulate by substance rather than form and ensure that there anti-avoidance provisions are included in legislation.

(1) The proposals of the Consumer Measures Committee on Truth in Lending will apply to certain of the issues raised in this paper (e.g. disclosures in rent-to-own and regulation of default charges). It would be useful to identify further areas such as collections or repossessions where minimum standards might be proposed.

(2) There appears to be reduced public resources assigned to the enforcement of consumer protection law in Canada and the private bar has not found it economic to provide legal services to low income individuals with credit or financial problems. Community legal clinics do not in general develop expertise in credit problems. There may be a role for the establishment of community credit legal clinics which might be funded by institutions such as the Ontario Law Foundation.

(3) There is probably little disagreement that legislation should ensure that there is proper disclosure of price and terms in relation to practices such as payday loans and rent-to-own . However, given the significance of the findings on bounded rationality, serious thought should be given to the form and content of the disclosure (including the role of the APR).

There are good economic and social reasons for increased provision of comparative price and term information on the alternative financial sector. This could facilitate comparisons with other offerings within the alternative financial sector and alert consumers to the fact that they may be paying a high price compared with alternatives within the mainstream financial sector which they qualify to use.

(4) It may be desirable to analyse the area of small loans ($50-$1000) which are made over the short term as a discrete area of regulation. This would include payday loans and pawnbrokers. There may be a role for legislative harmonization in relation to these forms of transaction

The Federal and Provincial governments through the Consumer Measures Committee might develop model Acts for Payday Loans and pawnbrokers which could provide a baseline of protection for consumers. The model Payday Loan Act in appendix 1 could be used as the basis for a model payday loan act.

In relation to small loans over a short term such as payday loans or pawnbroking, the interest rate is inevitably high when expressed as an effective annual rate and section 347 may not be the appropriate method of regulation. At the same time it would not appear that the existence of section 347 has had much impact in preventing the growth of payday loans. If there appears to be little enthusiasm for using section 347 of the Criminal Code to protect vulnerable consumers in relation to this type of loan then the section should be amended. At a minimum such a step might stimulate public debate over the appropriate role of interest rate ceilings in protecting vulnerable consumers.

There is a good case for price or interest rate controls as a mechanism to prevent against *excessive* charges in relation to both payday loans and pawnbroking. These could be fixed or graduated ceilings as existed under the Federal Small Loans Act (see Appendix 2) or the Tax Rebate Discounting Act. These ceilings should be sanctioned in the case of payday loans by non-enforceability of the principal and interest in addition to the criminal sanction.

The existence of payday loans suggests that there is a need for short term credit ($50-$1000) which is currently being met by relatively costly loans in the alternative financial sector. There are several policies which might be developed to meet this need at reasonable cost (see also V above):

- Rent banks which provide one time rental assistance to cover short term arrears have operated successfully in the US and Toronto has a pilot project. One possibility would be the development of a non-profit form of short term lending which might also offer information and advice on credit and financial institutions.

- Short term loans for necessaries such as automobile repairs might be included within welfare to work programmes

- There should be continuing experiments in such areas as lifeline banking and the encouragement of experimentation in the provision of savings and credit services by non-traditional providers (such as supermarkets)

- Community groups may play an important role in communicating information on credit and financial services to members of the community which is sensitive to the needs of the community. The example of PEACH in the Jane-Finch area of Toronto could be a model for further development.

Table of Contents

Introduction 1

I: The Vulnerable Consumer 1

II: The Alternative Financial Sector 3

1. Cheque cashing 5
2. Payday Loans 7
3. Pawnbrokers and second hand dealers 11
4. Rent to own 11
5. Tax rebate discounting: Lessons for Policymaking? 13
6. Loan Brokers 15
7. Finance Companies and consumers 15
8. Other forms of small loan and sub prime lending 16
9. Why do individuals use the alternative financial sector? 17
10. Summary 18

III: Rationales and Explanations for Regulation 19

1. Traditional neo- classical economic framework 19
2. Bounded rationality, cognitive distortions and market manipulation 22
3. Equity and distributive justice 24
   (1) Fairness 24
   (2) Financial Exclusion 25
   (3) Consumer protection and "positive welfare" 25
4. Explanations of existing patterns of regulation of low income markets 26

IV: Assessment of Existing Legal Framework 27

1. General Issues 27
   (1) Federal/Provincial jurisdiction 27
   (2) The Form of consumer protection legislation in relation to vulnerable consumers 28
   (3) Enforcement issues 28
2. Common law doctrines and private law remedies 29
3. Trade Practices Legislation 29
4. Information policies 30
5. Controlling Terms 31
6. Controlling Terms: Interest Rate Ceilings 31
7. Licensing and other controls on entry 33
8. Bans 34
9. Human Rights Legislation 34

V: Expanding Choices **36**
1. Lifeline banking 36
2. Credit Unions 37
3. Direct deposit 39
4. The Role of Community Institutions 39
5. Short Term loans for necessities 40
6. Counselling and education 40

VI: Conclusion **40**

Endnotes **41**

Appendix 1 **56**

Appendix 2 **66**

Introduction

This paper concerns access to credit for vulnerable consumers. Its focus is consumer protection but the topic is wider than conventional understandings of consumer protection. It raises issues such as financial exclusion and its relationship to social exclusion, as well as issues of urban development. Some of the issues discussed are not new to the public policy agenda. The search to provide small loans to lower income consumers at reasonable prices has a long history[1], and the Croll-Basford report in 1967 outlined a central issue in consumer credit policy to be "the plight of the low income families who are from time to time in desperate need of credit for necessary goods and services but to whom commercial credit is either not readily available or not available at all"[2]. Students of consumer law are familiar also with David Caplovitz' classic text *"The Poor Pay More"* written in the early 1960s.[3] There have, however, been changes in the economy and social structure since that time and I examine the implications of these changes for consumers as well as assessing approaches which have been taken to protect vulnerable consumers. The Paper is divided into five parts. Part I explores the concept of the vulnerable consumer and outlines those socio-economic factors which contribute to the growing segmentation of consumer credit markets, a phenomenon which has led some writers to identify the rise of an alternative financial sector. Part II provides a thumbnail sketch of this sector. Part III outlines rationales and explanations for regulation of consumer credit markets serving vulnerable consumers. Part IV provides an assessment of the existing legal framework of consumer credit protections as they affect vulnerable consumers, Part V evaluates some initiatives for expanding consumer choices and Part VI supplies a brief conclusion. Recommendations for further research and policy making are included in the executive summary.

I: The Vulnerable Consumer

At the outset it is necessary to identify more clearly the circumstances which render consumers vulnerable. The concept of the vulnerable consumer in the credit market includes those who are more likely to pay a very high price for credit, and those excluded from mainstream credit or from access to financial services. Low income or financial distress either as a temporary or a continuing problem can place a consumer in either of these two categories. Certain groups such as single parent mothers, unattached elderly men and women, and unattached individuals under 25[4] have a much higher likelihood of experiencing low income There is also an a overlap between low income and groups protected under Human Rights codes. In a recent study in Ontario, Ornstein showed a clear overlap between low income and female lone parenting, young unattached people[5], recent immigrants and members of some visible minority groups.[6] In addition, those suffering a long term illness or disability may also fall within this category.

There are also a number of broader trends in the economy which are relevant to the identification of vulnerability among consumers. First, there are the high debt- to- income ratios among consumers. Debt-to-disposable -income ratios have risen from what the Bank of Canada described as a "record level" of 78 percent in 1992 to over 100 percent in 1998[7]. A central question in relation to these ratios is the distribution of this debt among different income groups and its relation to household asset formation. Debt-to- income ratios are not necessarily problematic if consumers are also acquiring assets such as homes and consumers have a high and secure income stream. Unfortunately contemporary data on this issue is not yet available and the most recent study was conducted in 1984. The 1984 data suggested that debt/income ratios were higher for those on lower incomes and those who were younger.[8] Thus, individuals in the lowest income quartile who were between 25-44 had a consumer debt-to-income ratio [excluding mortgage debt] of

approximately 45 per cent compared to approximately 13 percent for similar groups in the top two quartiles. Analysis of US data indicate that high consumer-debt servicing ratios (excluding mortgage debt) were concentrated among the low to moderate income group and that this group had the least amount of financial assets as a cushion to meet their debt obligations.[9]

Second, there is a declining ratio of savings to disposable income among consumers. Studies indicate a very low ratio of savings to disposable income in Canada which has fallen from 15 percent of annual disposable income in the mid 80s to almost zero by 1998[10]. Without access to savings individuals may need to borrow to smooth over unexpected income shocks and, for those already heavily committed with credit obligations, they may have difficulties in obtaining further credit from a bank.

Third, there is the issue of consumer access to financial services. There are varying estimates of individuals who do not have a relationship with a financial services provider. The White Paper on Financial Services suggests that 650,000 adults do not have an account with a financial institution and that low income consumers find financial institutions reluctant to serve them[11]. Other research suggests that 3% of adults do not have bank accounts but that this rises to 8% among households with incomes less than $25,000.[12] A recent survey in the Jane-Finch community in Toronto indicates that 10 per cent of those interviewed do not have bank accounts.[13] Access may be less problematic in some areas of the country such as Quebec where there is a strong credit union movement. Only 2.5 percent of adults in Quebec with incomes under $25,000 did not have bank accounts compared with 10.4% in the rest of Canada. There is also evidence that banks are closing branches in poorer neighborhoods of larger cities and in small rural communities[14]. Individuals with small balances may also find that banks put holds on any cheque deposited so that it is not possible to access immediately the full face value of a cheque.

Fourth, there are also changes within the financial services market. The market for small loans has been replaced by lines of credit and credit cards. The introduction of datamining technology permits finely grained segmentation of the consumer market with the identification of high value consumers to whom banks may attempt to develop "relationship banking" while at the same time discarding or discouraging low value consumers. There is a more general concern that there is emerging "two-tier marketing" in a number of industries where retailers use a dual marketing strategy with one strategy at the high end and one at the low end, and no longer attempt to appeal to a broad middle class[15].

Fifth, consumer may also be vulnerable because of discrimination. Recent immigrants may face difficulties in obtaining credit and access to financial services. Unfortunately the Task Force on Financial Services did not investigate issues of discrimination against minority consumers in the marketplace. Although there is a history of legally sanctioned race discrimination in private markets in Canada[16], and evidence of discrimination in rental housing markets, there has been little attempt to obtain systematic data on this topic. It might be assumed that with the development of credit scoring and the creation of an impersonal market for consumer credit that there would be little role for direct discrimination. The market will ration credit efficiently in an objective manner. Unfortunately, the reality is not quite as straightforward and I explore this topic further in Part IV.8. The White Paper on Financial Services also identified potential discrimination against the elderly and the disabled as issues which should be addressed by financial institutions.

Finally there is a danger in the use of the concept of the vulnerable consumer. It draws on a possible contrast with the rational, confident consumer who knows what they want and how to achieve their goals. Vulnerable consumers are therefore construed perhaps as weaker in some way than the rest of the population and deserving of protection. As we shall see there is not much support for this "weak

consumer" thesis as a general explanation of lower income behaviour. A further assumption is that the vulnerable consumer is an exception, representing the minority of consumers. But studies of middle and upper middle income markets such as the purchase of mutual funds suggest that consumers in this market are also vulnerable[17] and there is evidence of manipulation of consumers' "bounded rationality" in all consumer markets.

A recent report by the Canadian Council on Social Development noted some of the above trends in constructing an "economic security" index. It found evidence of increasing economic insecurity with almost two thirds of working age Canadians losing faith in the ability of government support programmes to adequately sustain them while looking for a job and with only a small minority being able to sustain themselves for 12 months on their savings[18]. Robert Kerton cites to research which concludes that the more that an individual believes that financial and credit issues are beyond their control, the more likely they are to use credit unsuccessfully[19]. In this connection, the Canadian Council cite to the rise in the personal bankruptcy rate over the past two decades with four times as many bankruptcies in 1998 as in the mid 1980s.[20] Studies indicate that a primary reason for current bankruptcies is adverse employment changes among the lower and middle to lower income groups[21] . There also appears to be a high rate of representation of younger consumers (under 30) declaring bankruptcy. There is also the growth of the alternative financial sector, the topic of this paper. These developments must be set against the background of increasing income inequality over the past 25 years[22]. Family income declined throughout the early 1990s with low income families suffering a decline twice as large as higher income families.[23] Although this inequality has been contained until recently in Canada by tax and transfer programmes there are signs that with changes in these programmes this may no longer hold true.

We might make the following summary concerning the concept of the vulnerable consumer. There are groups who are extremely vulnerable in terms of their exclusion from the financial system and/ or who may be required to pay extremely high credit charges. There is also a larger group of consumers who may be vulnerable and who may be using credit to maintain living standards in the face of stagnating incomes[24]. Increasing inequalities of income and a reduction in the middle income group, coupled with high debt to income ratios, and a reduction in savings to income, make individuals vulnerable to unexpected changes in circumstances. A study in the US indicated that the bottom 40% of consumers borrowed to compensate for stagnant incomes[25], while in the UK the Policy Studies Institute concluded that ' poorer families, on the whole, use credit to ease financial difficulties; those who are better-off take on credit commitments to finance a consumer life-style'.[26] There is probably a significant credit market for those who slip into difficulties. The growth in caseloads of credit counselling agencies is one sign of larger number of overburdened debtors. A further dimension here is the role of collection agencies. In Ontario, collection agencies top the list of consumer complaints and inquiries[27], perhaps reflecting the rise in collection activity, and there is evidence that consumers are often unaware of their rights in relation to collection agencies.[28]

II: The Alternative Financial Sector

It would be misleading to suggest that one can draw a precise picture of an alternative financial sector, sharply differentiated from a "mainstream" financial sector in terms of customers and business practices. The description identifies those institutions which target primarily individuals within the bottom third of the economic ladder or those with spotty or blemished credit records and includes the phenomena of "fringe banking"[29] and "sub-prime lending"[30]. In Canada there has been the rise of the cheque cashing industry since the early 1980s, the more recent phenomenon of "payday loans" and also an increase in the

number of pawnbrokers .[31] The idea of "alternative" is intended to capture the increasing segmentation and differentiation of consumer markets. It would be mistaken to view this industry as a monolith or all consumers of its products as drawn from the same social and economic background. However, there are sufficient similarities that the description of an alternative financial sector does provide a useful framework for focusing on common public policy issues and themes.

It is difficult to gauge the size of this alternative financial industry. Table 1 (below) indicates the relative market shares of different financial institutions in relation to consumer credit and residential mortgage credit in 1998. It is difficult to assess how much of this lending is sub-prime. It might be assumed that some consumers of finance company credit might be sub-prime (see below, finance companies and consumers). There is also anecdotal evidence of this form of lending by banks.[32] The total amounts lent by institutions in the alternative financial sector may be very small in comparison with amounts lent by major financial institutions. However, they may engage in large numbers of individual transactions with consumers.

Table 1

Consumer Credit and Residential Mortgage Credit 1998

Consumer Credit	%	Residential Mortgage Credit	%
Chartered Banks	62	Chartered Banks	59.8
Trust/ Mortgage Loan	9.5	Trust/ Mortgage Loan	5.7
Credit Unions/Caisses	9.6	Credit Union/Caisses	13.4
Life Insurance	2.75	Life insurance	5.1
Finance cos. and others	6.5	Finance Cos. and other	6.9
Special Purpose co(securitisation)	8.6	Special Purpose cos. (securitisation)	2.2
.....	...	Pension Funds	2
.....	....	NHA mortgage-backed securities	4.4

Note: Percentages may not add to 100 due to rounding

Source: Statistics Canada (http://statcan.ca/english/Pgdb/Economy/Finance/fin21.htm)

Analysts in the US have also noted the increasing scale and consolidation of the market players with the emergence of pawnbroking, cheque- cashing, and rent-to-own chains which raise capital on the capital markets, as well as the entry of mainstream lenders into this market. Consumer Reports suggests that many segments of this industry are highly profitable and that the ability of some lenders to raise capital on the stock market permits them to make high-risk, high profit loans.[33] This means that those who invest in the stock market (generally middle and upper income individuals) profit from loans to lower income and more vulnerable consumers. Consumer Reports documents also the growing political power and influence of parts of this industry in achieving favourable state regulation[34].

There are certain common features of the alternative financial sector. First, individual consumers pay higher, sometimes much higher, prices for goods and services in this sector than those provided in the mainstream financial sector. Second, although it may be argued that these institutions are extending credit to higher risk borrowers and therefore serving a legitimate need, it is also the case that there is some evidence of fraudulent selling practices and oppressive collection tactics.[35] At the same time I do not assume that the phrase alternative market should be equated necessarily with deviancy, the argument developed by Caplovitz in his pathbreaking study. There exist fraudulent and deceptive practices in both the mainstream and alternative financial sector.[36] Third, I would hypothesise that fewer social resources in Canada are devoted to monitoring and policing the alternative financial sector on a continuing basis than middle income markets[37]. There is therefore both the regressive nature of prices in these markets coupled with the regressive nature of state enforcement. Fourth, it is argued that regulatory enforcement is particularly problematic in relation to this sector because of the imaginative ability of some providers of alternative financial services to restructure transactions to avoid the bite of regulation and the low costs of market entry and exit. [38]. Finally, the connections between the mainstream and the alternative should be kept in mind. There is evidence that banks, notwithstanding their public relations efforts, are not strongly committed to cultivating lower income clients or branches which serve lower income areas which do not generate sufficient profits in this age of shareholder-driven capitalism. The existence of the alternative sector may be partly a consequence of the practices of mainstream financial institutions.

1. Cheque cashing

During the past two decades there has arisen a professional[39] cheque cashing industry in Canada. There are higher percentages of cheque cashers per capita in BC, Alberta, and Ontario, than might be expected based on their respective percentages of the national population while Quebec has a smaller per capita cheque cashing industry but a larger percentage of pawnbrokers[40]. The Canadian cheque cashing industry is relatively concentrated with one dominant provider accounting for a large percentage of the total cheque cashing stores. Although the US market is more fragmented there is the now the rise of cheque cashing chains which raise funds on the capital markets. A leading US company has indicated in material submitted to the US securities and exchange commission that there is substantial opportunity for growth in the industry because of the growth in the lower income population and the failure of commercial banks and traditional service providers to address the needs of lower income individuals.[41]

Research for the Financial Services Task Force indicated that 8 per cent of the Canadian population had used cheque cashing services.[42] There may be significant regional and local variation in the use of cheque cashing services. A recent survey in the Jane/Finch area of Toronto indicated that 26% of individuals surveyed had used cheque cashing services.[43] Clients of cheque cashing companies are generally younger than the general population and are drawn from lower income groups[44]. The average value of cheques cashed is between $250 -$300[45]. Many customers are unskilled workers or independent contractors. They may receive payments irregularly and lack sufficient income to accumulate savings.[46] Cheque cashing services are not used solely by individuals who do not have a bank account[47], and they may often be used because of the convenience of the operating hours and the ability to cash a cheque immediately (even a postdated cheque) . A principal form of cheque cashed is a payroll cheque. Cheque cashing companies often offer a number of additional services and these may include payday loans, money orders and transfers, bill payments, phone cards and US currency exchange. Some stores offer mailbox rental and it is estimated that over 50% of customers used other services in addition to cheque cashing.

Our small survey of cheque cashing charges in the Toronto area (see Table 2, below) indicates a percentage charge among firms around 2.9% and, coupled with the "item fee", charges for cashing a $100 cheque varied between $3.00 and $5.20, reflecting a significant price dispersion[48]. A recent Consumer Federation of America (CFA) study in the US indicated the average cost of cashing a paycheque to be 2.34% and it would appear that charges for cheque cashing in Canada are generally significantly higher than in the US [49]. The identification required to cash cheques varied between one and two pieces of government- issued photo ID. Some companies registered individuals with the cheque cashing agency either in a centralised data base or through obtaining a membership card.[50] Most cheque cashing companies seem to require similar identification to that required by banks under the 1997 agreement on cashing government cheques.

Table 2
Cheque Cashing: Greater Toronto Area

Cheque Casher	Per Item Fee	% of Cheque Amount	Initial Fee for Membership	Total Fee Per $100 Cheque
A	$1.99	2.9%	None	$4.89
B	$1.99	2.5%	None	$4.49
C	$2.25	2.99%	None	$5.24
D	$1.99	2.9%	None	$4.89
E	None	2.9%	None	$2.90
F	$1.59	2.9%	$2.49	$4.49
G	$2.49	2.75%	None	$5.24
H	1.79	2.9%	None	$4.69
I	Under $100 - $3 flat fee Over $100 – $1.99	None 2.75%	None	$3.00
J	Under $200 - $5 flat fee Over $200 – none	None 2.5%		$5.00

Several commentators have pointed out that cheque cashing is an expensive way of conducting financial transactions, particularly for those on low incomes. The charges for a minimal transaction bank account are approximately $10 per month[51]. If one assumes that an individual uses a cheque cashing business on a regular basis, and is also buying money orders for bill payments then cheque cashing is expensive. Simply cashing two cheques a month for $300 would cost over $20 at many cheque cashing outlets. A different way of thinking of the price differential between depositing a cheque in a bank and using a cheque casher is to view the cheque casher as providing an advance to the consumer in those cases where a bank might put a hold on a cheque for a few days. A charge of $4 on a cheque for $100 which could be drawn on at a bank within three days is effectively a three day loan at 4%. This represents an annualized percentage rate of over 300 percent. In addition, the use of cheque cashing services does not provide the opportunity for depositing a portion of the amount cashed and may encourage immediate spending of the cash received.

One issue is whether these businesses earn excessive profits. In general the prices surveyed are higher than in the US and appear to be higher than price ceilings on these charges in a number of states[52]. There is also clearly some price dispersion, a signal of a lack of competition. Given the relatively high consumer transportation costs relative to the small amount of the transaction, firms may compete with other cheque cashers in similar locations. This may require an analysis of cheque cashing as a form of monopolistic competition[53]. In addition, to the extent that there may be a certain social stigma attached to

the business of cheque cashing, this may create informal barriers to entry. Caskey concludes that these characteristics may make cheque cashing somewhat more profitable than other businesses but notes that cheque cashers in the US have high operating costs because they have longer opening hours than banks, and each cheque must be evaluated individually by a person who is able to distinguish high risk from low risk cheques. They may have to pay higher business insurance, hire armoured car service and pay for cheque clearing services with a bank and for cash advances from banks.[54]

There is no industry-specific regulation of the cheque cashing industry in Canada. One question is why there appears to be regional disparities in the number of cheque cashing outlets within Canada. Two factors might account for the relative paucity of cheque cashers in Quebec. These are the greater ease of access to financial institutions through the Caisses Populaires (so that Quebec has a significantly lower percentage of "unbanked" compared with other provinces) and the prohibition on charging a fee for the negotiation of a government cheque.

2. Payday Loans

Payday loans or advances have become common in Canada. Payday loans are provided by cheque cashing companies or by companies which specialise in these short term loans. In a payday loan a consumer generally provides a cheque (which may be post-dated) to the payday loan company in return for a cash advance which is less than the face value of the cheque. The company will then hold the cheque until payday (usually a maximum of 14 days). At this point the consumer may redeem the cheque, allow it to be cashed, or rollover the original advance with a further post dated cheque.

Several cheque cashing companies which we surveyed in the Toronto area provided payday loans for amounts which ranged between $100 and $500 or 30% of the customer's next pay cheque. The average advance provided by a dominant provider is $250.[55] Cheque cashing companies have similar requirements for making these loans. These are: a personal chequing account, one or more pay stubs as evidence of recent stable employment, a bank statement or pass book, and proof of address on a utility bill. Individuals receiving government cheques must have money directly deposited to their account to obtain a loan. Consumers must usually have a minimum income above $14,500.

Some evidence of the large growth of this industry in the US is that there are currently 8,000 payday loan shops in the US, up from 300 seven years ago[56]. The largest company is Ace Cash Express which has about 900 stores and a revenue of $100 million in 1998, twice that of 1996. It provides this service in addition to cheque cashing, bill payment services, money orders, and money transfers. It has a return on equity of 19.88% and the *Denver Post* has suggested that it is one of the most promising institutions of the fringe banking sector[57] and it has recently signed an agreement with a US bank which will permit it to offer short term loans which will be accessible through ATM machines[58].

Providers of payday loans believe that they meet a need which is not met by traditional alternatives such as charge cards, lines of credit, loans from families and friends, payroll advances from employers, pawnshops, and overdrafts. One company suggests that these alternatives are unattractive because:

> consumers may dislike the complexity, inconvenience, or lead time associated with such alternatives, (ii) the minimum amount required to be borrowed or the repayment or other terms may be unsatisfactory in light of consumers' needs (iii) consumers may be ineligible by virtue of credit or other criteria (iv) consumers may be unwilling or unable to pay the high costs of NSF and

overdraft fees charged by banks and merchants or (v) consumers may fear the personal embarrassment that may result from the denial of credit or from approaching family or friends for money.[59]

The use of payday loans may be partly motivated by consumers' fears of the high costs of bank charges for cheques drawn on insufficient funds and critics argue that payday loan companies exploit this fear.[60] There is evidence that users of payday loans are not drawn from the lowest income level and may be drawn from a more stable group than consumers of cheque cashing services. The US company Check into Cash states that the average customer earns over $34,000, has been at his or her job for nearly four years, and that 36% of customers own their own homes.[61] In Canada, a survey conducted by Money Mart indicated that 58% of payday loan customers are male, with a median age of 32.4. Eighty two percent earned $40000 or less. Twenty per cent were classified as professional, followed by 18% skilled trades and between 12% and 4% each for the categories of labourer, business, retail clerk, restaurant/hotel.[62]

It is not clear whether payday loans are used solely for emergencies or are used by consumers on a continuing basis (although these two categories are not mutually exclusive).[63] In the US, a focus group study claimed that they are used for home or car repairs, while a recent article in the New York Times suggested that payday lenders are serving "people who need small sums to get over a hump, like paying for a medical prescription or buying tires for a car" and who are unable to obtain credit cards or are maxed out on their credit cards.[64] In Canada, there is some evidence that they may be used for discretionary as well as emergency expenditures.[65] There is not a great deal of data on charge-off rates for payday loans but the supervisor of Colorado payday loans indicates a charge-off rate of about 3.6%.[66]

Companies which provide payday loans have different methods of structuring the loans with some companies charging a fee as a dollar figure per $100 lent, while others separate out "item fees" for cheque cashing from interest. Table 3 (see next page) indicates the costs of payday loans by providers in the Toronto area. Those companies charging an item fee irrespective of the amount lent result in a higher cost on $100 lent than higher amounts. For example, borrowing $200 from company A would cost significantly less than borrowing from those companies charging $20 per $100. In general, those companies which provided only payday loans (F,G,H) were more expensive and one of these companies quoted an NSF charge of $100. There is therefore significant price dispersion among lenders and the different methods used to quote the costs of these loans do not provide a consumer with a transparent method of comparing the total costs of the loans.

Table 3
Pay Day Loan Survey----Greater Toronto Area
For 14 day loan

Lender	Min Loan	Max Loan	Fee as Stated	Roll Over	Graduated Lending Scheme ***	APR** to Borrow$ 100 7 Days	APR ** to Borrow $100 14 Days
A	$100	up to 30% of customer's next pay	1% face per week + 12.99 item fee (item fee waived if loan repaid before next pay day)	No	No	727%	390%
B *	$115	$225	2.5% of face + $1.99 item fee **** + $9.95 loan fee	No	Yes	670%	335%
C		30% net up to $300	Flat fee 15$ per $100	Yes	No	780%	390%
D	$100	$500	Graduated flat fee $20 for $100 $30 for $200 $40 for $300 etc	No	Yes – will lend more and decrease charge/$100	1040%	520%
E	representative would not talk over phone about loan rates						
F	$200	Depends on Familiarity with operator	Flat Fees 5$ + $20 per $100 (fee + admin charge)	No	No	1300%	650%
G	$100	$500	Graduated flat fee $25 for $100 $45 for $200 $65 for $300 etc	No	No	1300%	650%
H	$100	$1000	Flat Fee $20 per $100	No	Yes	1040%	520%

NOTES:

* B Calculation (a) cost of loan: 2.88 (2.5% of 115) + 11.94 = 14.82
(b) 14.82 of 115 = x of 100 –> x=12.89
(c)APR then calculated for 7 and 14 days

** APR calculated using "nominal" not "effective" method.
--Nominal method is used for calculating consumer loans in North America and Europe, excluding the UK.
--Effective method which is a more complex actuarial calculation is used in calculating the rate of interest under the criminal interest rate (section 347 Criminal Code). The effective rate would be significantly higher than the nominal rate for short term loans such as payday loans.

***Graduated lending scheme denotes that the outlet will initially loan minimum amount then increase loans as customer becomes a familiar client

****Item fee is charged on the entire cheque, not for each $100 borrowed. For those sites charging an item fee, borrowing $100 has a much higher APR than borrowing a larger amount.

However the fees for the loan are structured, an individual will normally pay at least $15 for a loan of $100.The column headed "APR to borrow $100" includes as interest charges all charges levied by the companies in connection with the loan. This approach follows the broad definition of interest in section 347 of the Criminal Code and could result in many payroll loans violating the criminal interest rate of 60%[67]. The Supreme Court of Canada in *Garland v. Consumers Gas*[68] indicated that the broad language of section 347 should be interpreted according to substance not form in order to prevent lenders avoiding the statute by manipulating the form of payment exacted from debtors. Undoubtedly lenders might argue that since they are not required to accept repayment of a loan in cash then they may charge a fee for processing repayment by cheque which is not related to the advancement of credit and should not therefore be included as interest. However, acceptance of such an argument would permit widespread evasion of the statute and be contrary to the approach taken by the Supreme Court.

There is also a further aspect of section 347 which is relevant to the calculation of interest. In Table 3 we have used a nominal rate of annual interest. This is simply an annualization of the period rate so that, for example, 1% a week translates to an annual interest rate of 52%. This is the form of calculation which is required in credit disclosure statutes in North America. However, section 347 of the Criminal Code requires interest to be stated as an effective not a nominal interest rate[69]. Thus a nominal interest rate of 0.92% per week equals an annual nominal rate of 48% but represents an effective rate of 61.25%[70]. Annualized effective interest rates on small loans over a short term tend to be very high and in Part IV. 6, I discuss the normative issue of the appropriateness of section 347 as a method of regulating these forms of transactions.

Spokespersons for the industry defend the high prices for these loans by arguing that the concept of APR is not appropriate to these short term small loans and that the appropriate comparison should be with the cost of NSF charges by financial institutions[71]. Apart from the high rate of interest charged for these loans, consumer advocates in the US have also identified abusive practices which are associated with some payday lending. These include the "rollover" or refinancing of loans where an individual pays further fees and may become entangled in high credit charges[72]. A variation of this is where an individual repays one cash advance with a cash advance from another outlet or where an individual becomes a regular user of payday loans rather than using it for emergencies.[73] Further concerns relate to high charges if a consumer's cheque bounces (some companies charging $75 and up)[74] and threats to use the criminal justice system if a cheque is returned for insufficient funds[75]. This has led to general objections to the use of cheques as collateral for these loans.

There have been three responses by US states to the phenomenon of payday loans. In certain states these loans are subject to the state's small loans law and are effectively illegal since the interest rate ceilings are below the rates charged by payday lenders. In others the small loans Act exempts payday loans from interest rate ceilings. Finally, several states have passed statutes which authorize and regulate the price and terms of payday loans.[76] Some of the common provisions of these statutes are: licensing requirements: disclosure requirements for fees and identification requirements for cashing a cheque; specific interest rate ceilings: limits on the amount and period of a loan and rollovers and NSF charges. In addition, there may also be prohibitions on cashing postdated cheques and the provision for civil remedies which include the possibility of treble damages. A survey of payday lending in the US indicated that it continued to exist in states where it was prohibited such as Virginia and Pennsylvania. There are currently legislative battles in several states over the terms on which payday loans should be available.

3. Pawnbrokers and second hand dealers

There appears to be a growth in pawnbrokers and second hand dealers in Canada. The number of pawnbrokers in the Toronto area has almost doubled in the past three years and there has been a general increase in pawnbrokers throughout the province and in other provinces[77]. Several small chains or franchises appear to be developing.[78] In the US, Caskey charts the resurgence of pawnbroking in the 1980s and the National Association of Pawnbrokers in the US now claims a membership of 3,000 compared with 50 in 1988. Table 2 shows that Quebec has the largest number of pawnbrokers, followed by British Columbia, Alberta and Ontario. Pawnbrokers are primarily in the business of making small loans against the borrower's collateral. Since the loans are based on collateral they do not need to know about the individual's credit history. They will usually lend between 5-10 percent of the original price of the goods which represents about one-third to one-half the price which the broker can expect to receive for the sale of a good during the worst of times.[79] US data indicate that 70-80% of pawns are redeemed and there are similar redemption rates in Canada.[80] Loans are often for small amounts such as $50-100 dollars and for a relatively brief time period (one to four months) and many pledges are redeemed within a week or two. Veitch asserts that in New Brunswick pawners are primarily divorced and single parents, mostly women who require money without delay to pay for necessities before the arrival of government cheques.[81] Pawning may function therefore as an alternative form of payday loan for those without employment or in unstable employment.

There exists specific provincial regulation of pawnbrokers in Ontario and British Columbia which requires pawnbrokers to be licensed by municipalities. These statutes contain provisions concerning the keeping of records, disclosure requirements, redemption periods, restrictions on the types of goods which may be pawned, charges and interest rates and a variety of issues relating to crime control (police reports and access). The Ontario Act is rather dated and in need of reform. I was informed that in the Toronto area pawnbrokers charged interest of 5 percent per month. Given the expansive definition of interest in the Criminal Code , I would estimate that many pawnbrokers' charges contravene the usury provisions of the Criminal Code. There have been few prosecutions of pawnbrokers under this section.[82]

Second hand dealers buy goods from consumers and subsequently sell them. "Cash Converters" is a multinational firm which engages in this business. It would appear that there is some overlap between the clients of pawnshops and second hand dealers, which are also used by middle class consumers. Second hand dealers pay consumers similar prices to the amounts loaned by pawnbrokers. It is not clear whether some "buy-sell" arrangements are in substance pawns where the pawner sells the goods to the broker subject to the right to buy the goods back within a period of time.

4. Rent-to-Own

Rent-to-own stores offer consumers the possibility of renting goods on weekly or monthly rental agreements with the possibility of obtaining ownership of the goods after making payments for a period of 18 to 36 months, or by exercising an early purchase option. The type of goods offered by these stores include furniture, home electronics, appliances, jewelry, and home furnishings accessories. The industry in Canada includes national chains and local stores. Rentown, a furniture and appliance rental store, founded in 1991 in Alberta, operates 134 stores in 82 cities in Canada under such names as Rentown, RTO centres, First Choice Rent to Own and North American TV and appliances. It has grown from revenues of $442,000 in 1992 to revenue of 56 million in 1997 and serves approximately 75,000 consumers. The president and founder Gordon Reydkal claims that "Rent to own is an underserved niche...There's

tremendous room for long term growth"...Rent to own is a good business. There's a large number of Canadians who lack savings and access to credit, and we're a mobile society in which people have short term needs".[83]

Rent- to- own stores are generally "targeting the bottom third of the economic ladder".[84]A study of rent- to-own consumers in the US concluded that the primary reasons for consumers' using the stores were: "(1) they want to obtain the goods right away rather than delay while they accumulate savings (2) they do not need to pass a credit-screening check at the rent-to-own stores; and (3) people like the lower periodic payments and the flexibility of discontinuing the contract at any time by returning the rented good to the store".[85]

Critics argue that rent-to-own stores charge usurious prices, with consumers paying two to five times the price which middle income consumers pay for similar goods. Rent-to own companies argue that they have higher collection costs and defaults because they are dealing with higher risks. An analysis of the industry in the US concludes that "the cost of the risks faced, as well as the costs of the services provided, are real, but overemphasized".[86]

Table 4, developed by Option consommateurs, illustrates the high prices paid for those who use rent-to-own as a method of purchasing goods. The table represents the costs for purchasing a brand name washer/ dryer with a cash price of about $850 ($968.62 with taxes) at two rent-to-own stores and financing the same purchase through a finance company and a bank. The implementation of the consumer measures committee proposals on truth in lending should create greater transparency in rent-to-own transactions, and protect against high late payment fees. However, there have also been criticisms of the repossession practices of some rent-to-own companies which may evade protections on seizure and sale which are applicable to credit sales and loans.[87]

Table 4
Comparative cost of washing machine/ dryer at rent-to-own, finance company and bank

	Rent-to-own A	Rent-to-own B	FinanceCo	Bank
Monthly Rental Costs* For 24 months	$104.59	$98.63	$51.72	$44.71
Total Cost (if all payments made on time)	$2521.56	$2395.62	$1241.28	$1073.04
Approximate APR	117%	110%	25%	10%

*Monthly rental cost includes taxes and insurance

Source: Option consommateurs, Dossier, Magazine Consommation "Rent-to-own, where they sell at two to three times more than elsewhere", Maryse Guenette

5. Tax rebate discounting: Lessons for Policymaking?

Tax rebate discounting describes the practice of tax preparers providing individuals with an advance on their tax refund. It is in substance a short term loan[88] and the consumers are charged a fee for this service. Tax rebate discounting is used primarily by lower income individuals. Contemporary data indicate that in 1995 (most current information available) the vast majority of discounting tax filers earned less than $20,000. They are generally under 34 (64%) and most are single (72%). More men than women discount in every income bracket except between $10,000-$19,999.[89] The average amount paid to the taxpayer in 1997 was $821.79. Most discounts are electronically filed and these returns are processed within two weeks. The industry is comprised of a number of large national chains such as H & R Block as well as small one person operations. It had a turnover in 1997 of $525 million with gross profits of approximately 50 million. Table 5 charts the development of the industry since 1990. It would appear to be currently an industry in decline.

Table 5
Overview of Operation of Tax Rebate Discounting in Canada 1986-1997

Year	Tax Discount companies	Locations	Refunds discounted	Total Value of Refunds	Avg. payment to taxpayer
1986	191	1486	722251	537715631	744
1987	182	1474	880587	605329974	687
1988	207	1596	906537	686874615	758
1989	210	1653	965889	827735280	857
1990	206	1664	1171641	1073123359	916
1991	223	1734	1108439	982767291	887
1992	217	1693	1088546	957833963	880
1993	217	1416	757482	566988299	748.52
1994	242	1434	747646	560077949	749.12
1995	217	1520	802185	588214457	733.27
1996	284	1372	667742	538447229	806.37
1997	288	1313	639241	525324961	821.79

Sources: 1986-89 Consumer and Corporate Affairs Canada; 1990-97 Revenue Canada.

The development of the regulation of Tax Rebate Discounting provides some useful material for reflection on regulation of the alternative financial sector. Tax rebate discounting appears to have become a public issue in the mid 1970s with a number of media exposes which characterized discounters as "social vultures preying on the poor"[90], drawing attention to the astronomical annual interest rates involved in these transactions. An attempt was made by British Columbia (unsuccessfully) to prosecute tax discounters under general unconscionability legislation. It was stated by the court that they could not determine whether the transaction was unconscionable without looking at all the circumstances of the case[91]. Although there were calls to ban the rebate practice this did not occur, (but note below the position in Quebec) and there were a variety of provincial responses. British Columbia legislated maximum discounting rates of 15

percent. Manitoba, Saskatchewan and Ontario, mandated 5 percent. The British Columbia legislation was challenged unsuccessfully as an infringement of Federal jurisdiction over interest[92]. The Federal government initially proposed abolition of ceilings on small loans as an encouragement to more traditional moneylenders to provide these short term loans. Ultimately , however, Federal legislation was enacted (at the request of all provinces) which required discounters to register, established a discounting rate of 15 percent of the refund which would include all fees and charges, and imposed detailed disclosure requirements.[93] Tax discounters claimed at the time that this rate would put them out of business. They also argued that they were not engaged in the business of money lending but entered buy-sell agreements with their clients.

After the passage of the legislation the tax rebate discounting business grew exponentially from a mere 7000 transactions in 1979 to 61,500 in 1981 and 385,000 in 1984. Two large firms, H&R Block and BenTax, entered the market and there was increasing consolidation within the industry. It is possible that attracting these larger firms into this market by providing a legislative framework was one of the objectives of the legislation. Amendments to the legislation in 1985 reduced the amount which could be charged by a discounter to 5 per cent for amounts over $300.

Critics argued that the legislation legitimated and stimulated the growth of an industry that would not exist if the government paid rebates in a timely manner. There has also been criticism of the enforcement of the legislation with few prosecutions, low fines and a judiciary unwilling to view these offences seriously. Professor Hasson has drawn the comparison between the paltry fines handed out to individuals who take advantage of the low income clientele of discounters compared to the severe penalties handed out to low income individuals in welfare deception cases[94]. Enforcement of the Act was transferred from the then Department of Consumer and Corporate Affairs to Revenue Canada in 1994. Table 6 (following page) shows that there has been a sharp rise in paper audits since that date so that public prosecutions are not necessarily an accurate measure of the level or the effectiveness of enforcement.

Table 6
Enforcement of TRDA 1990-1997

Year	On-site audits	Paper Audits	Codes deleted -non compliance	Prosecutions	Penalties
1990	7	44	1	-	-
1991	11	30	3	1	7500
1992	13	15	3	3	225017004000
1993	30	70	7	1	1000
1994	24	84	3	1	1700
1995	-	166	4	-	-
1996	13	168	1	-	-
1997	7	217	7	1	-

The position in Quebec differs from other provinces. Since Quebec prohibits discounting of provincial tax credits, it is uneconomical to provide discounting services and only 0.5 percent of the population use these services compared with 5 percent in Ontario.

Tax rebate discounting illustrates the variety of policies which might be used to address the issue of short term high interest loans. These included bans, price regulation through a legislative framework that encourages reputable (and more easily monitored?) firms to enter the market and the use of general consumer protection statutes (trade practices law) to address the problem. It would appear that general consumer protection statutes were relatively ineffective. Encouraging mainstream financial institutions to provide small loans was also unsuccessful although the legislation did seem to expedite the entry of large tax preparers.

It also illustrates some standard arguments which are used in relation to price regulation and interest rate ceilings. It was strongly argued by the industry that a 15 percent discount would put them out of business. This certainly did not occur. It was also argued by the Federal government that a ban would lead to an informal, illegal market. It is not clear whether this exists in Quebec. The topic demonstrates also the extent to which a consumer protection issue is often the consequence of a wider issue, in this case the practice of government not deducting tax accurately from taxpayers and delays in providing refunds. Some suggested that this was the "real problem" and the advent of electronic filing has significantly reduced the waiting time for refunds. There was also criticism of the media for trivializing complex issues through dramatic headlines concerning "social vultures". Finally, the courts appeared to have recognized this as an area of concurrent Federal and provincial jurisdiction, upholding both Federal and provincial regulation of the practice.

6. Loan Brokers

The practice of loan broking, offering to act on behalf of a consumer in obtaining a loan, has been associated with advanced fee fraud . This describes the situation where the broker demands an upfront fee from the consumer for their services in obtaining a loan and in many cases never obtaining the loan. Most of this business is directed towards individuals who are on low incomes and in dire financial straits or who, because of a bad credit record, are unable to obtain credit elsewhere.

Fraudulent loan broking could be regulated under some provincial Trade Practices statutes. The limitations on this legislation in Ontario led to the introduction of the *Loan Brokers Act*[95] which prohibits advance payments. The Act provides for criminal and civil remedies and the possibility of punitive damages.

7. Finance Companies and consumers

The larger finance companies which are members of the Association of Canadian Finance Corporations serve 1.74 million customers[96]. The ACFC describes the industry as providing financial services to three groups of Canadians: those who are underserved by banks, trust companies, credit unions and Caisses Populaires, those who are entering the credit market and those who require only small amounts of credit. They service both those who cannot and those who do not want to obtain credit from other sources. While they provide consumers with similar products to other financial institutions they also indicate that there are important differences in the companies' niche markets and customer service. They "provide credit to people who sometimes need help managing their credit, lend consumers the amount of money needed, however small the amount", and "provide ongoing financial counselling, if needed, for their customers and help them manage their monthly finances, including restructuring their repayment plans".[97]

The finance companies are not deposit-taking institutions as defined by the Bank Act, but because the parent companies of the major institutions [Associates, Avco, Beneficial, Household Finance Company,

Superior Acceptance and Trans Canada Credit] are foreign banks, they are classified as foreign "near banks" under the Bank Act. Finance companies are primarily regulated by provincial consumer protection legislation and mortgage broker legislation.

The consumer finance industry appears to be experiencing a resurgence in recent years.[98] Current returns on equity are similar to those of the best performing banks and returns on assets are two to three times higher.[99] The finance companies serve the consumer market through the provision of direct loans and through financing retail sales. The latter is less profitable but is an important source of new clients who will often be offered direct loans. Avco indicates that the average amount of new funds advanced was $2304 in 1996[100] and 48% of its loans are refinancings of existing loans to "supply additional needed money" to consumers[101]. Refinancings often provide additional small loans to consumers and it would appear that these are often actively marketed to consumers.

There have been concerns raised about this process of refinancing which may result in consumers paying much higher rates than if they negotiated a separate additional loan. There is a growing body of literature and judicial opinion in the US critical of what is described as loan "flipping"[102] and abuses associated with the sale of credit insurance with loans. Finally, some finance companies have been associated with abuses in sub-prime mortgage equity lending.

8. Other forms of small loan and sub prime lending

Other forms of the alternative financial sector include *credit repair companies*, which promise to improve a consumer's credit rating for a fee, but often engage in deceptive promises and are rarely able to do anything to improve a consumer's rating beyond what could be done by the consumer herself. They are often a variation of the advanced fee loan broking fraud. (See in the US the Credit Repair Organisations Act). *Subprime auto lending* has also given rise to concerns.[103]. This may take the form of an automobile pawn, where a set of keys or the ownership are turned over to the lender in return for short term loans (2 weeks to a month) of $100- $1000 at rates over 60%. Officials expressed concerns to me about the high charges and repossession practices of some of these lenders. There is also the area of *sub-prime mortgage lending*. The Federal Trade Commission in the US has noted the substantial growth of this profitable industry during the 1990s . While it has made home loans more widely available the Commission reported several abuses. These included "equity stripping" where the loan is based on the equity in the property rather than the borrower's ability to repay the loan. They are loans designed to fail and which permit the lender to acquire the borrower's equity. These schemes are particularly damaging because vulnerable borrowers often have no assets apart from their home. Other practices included loan flipping, and insurance "packing" where insurance is added to increase the profitability of the loan.[104] There was evidence that elderly consumers with significant equity in their homes were being targeted.

A further issue is whether some mainstream forms of credit are used differently by lower income consumers. Research in the US concluded that credit cards are used as a form of consumption insurance by poor and near-poor households[105]. During recessions middle and upper income households decreased their average balance, while the poor and near poor increased the frequency of positive balances. Some support for this thesis in Canada may be found in recent research on bankruptcy where a significant percentage of households declaring bankruptcy had attempted to address their cash flow problems by borrowing on credit cards. The majority of those declaring bankruptcy were from lower status occupations and income groups.

9. Why do individuals use the alternative financial sector?

There are several possible explanations for the use of high priced credit such as cheque cashing, rent to own, pawnbrokers and finance companies. First, individuals may have no reasonable choice because they do not have access to the "mainstream" financial markets to meet their immediate need. This lack of access may be temporary (bank account low in funds, credit cards over the limit, new entrant to credit market, fear of bounced cheque charges) or continuing. This explanation appears to be adopted in the recent report of the UK Office of Fair Trading.[106] A second explanation is that individuals may choose to deal with these high priced services rather than with the mainstream financial system. This may be because of factors such as convenience and the ability to obtain cash or goods immediately or a dislike of dealing with banks. A third explanation is that certain consumers, and particularly low income consumers, may be incapable of making rational choices and use these institutions because of limited planning, an inability to save and individual inadequacies. This suggests that low income consumers exhibit market irrationality. Finally, much literature suggest that many consumer choices in the area of financial services occur from habit and convenience. It is possible that there are significant numbers of consumers who initially use the alternative financial sector but who would later qualify for the mainstream market. They may continue to patronize the friendly finance company or rent-to-own company which has little financial interest in alerting the consumer to the change in the consumer's status.

It is obviously important to understand which is the primary reason for usage of the alternative financial sector because each reason might suggest a different policy response. If low income consumers have no real choice in relation to credit, because of their life situation, this would suggest, for example, that disclosure legislation will be of modest assistance to them. It is necessary to attempt to expand their choice set, perhaps by encouraging new institutions to enter the market.

The limited empirical evidence indicates that both the first and second explanation are relevant to usage of the alternative financial sector. For example, in relation to cheque cashing a significant number of individuals choose to use the service because of its advantages over the banking system, and not all rent to own consumers are excluded from the mainstream financial system. Interviews with street youth aged between 18-25 in Toronto found that the majority gave as reasons for the use of cheque cashing the ability to access cash immediately, the convenient locations and hours. Twenty nine percent said they had no option. Use of cheque cashing was much higher among those without bank accounts but half of those with bank accounts used the service .[107] Those who used the service were aware that they were paying a high price since most did not like the high fees and the danger of carrying the full value of the cheque in cash.

The market irrationality hypothesis as a characteristic associated with low income consumers has surprisingly little support, although it is explicitly and implicitly a theme in official and unofficial reports and legal judgments [108]. The issue of market irrationality and its manipulation by service providers is a broader issue than merely that of low income consumers and I discuss it in section 2 of Part III.

In discussing the presence or absence of choice among consumers it might be useful to reflect on the resources which are available to individuals to meet expenses. David Hulchanski has argued that most households in Canada draw resources from "five economies"[109]. First, there is the domestic economy of self-provision. A second is the informal economy of extended family, close acquaintances and co workers. The third is the social economy of neighborhood groups, community based agencies and so on. The fourth is the market economy and the fifth is the state in terms of social assistance,

unemployment and so on. This is a useful taxonomy because it expands the analysis beyond focusing solely on the market economy and stimulates reflection on the relation of these different economies to the need to use high priced credit such as payday loans. Individuals who are unable or unwilling to draw on the informal economy or the social economy may turn to payday loans, loan brokers or pawnbrokers.

10. Summary

It may be useful to draw together the separate strands in this thumbnail sketch of the alternative financial sector. First, there may be both commonalities and differences between these different phenomena which writers have placed under the umbrella of the alternative financial sector. One common factor is the significant growth in a number of these institutions such as cheque cashing, payday loans, rent-to-own and pawnbrokers. Second, there is the growth of consolidation in several of the industries. Third, each individual transaction is relatively small in economic terms but may be significant in relation to the budget or resources of the consumer. The small amounts at stake mean that few individuals are likely to litigate in the event of a dispute. Fourth, there is a tendency to structure these transactions in a form which evades regulation (rent- to- own, pawns as "buy-sell", payday loans as deferred deposits, tax rebate discounting as a sale).

There are a number of issues which are less clear. Although all these institutions serve lower income markets it is not clear to what extent there is an overlap in their consumer base. Payday loan consumers may differ in income and employment characteristics from those who use cheque cashing companies[110], and from those who use rent-to-own stores or pawnbrokers. Certainly not all lower income consumers use institutions such as rent-to-own, payday lenders or cheque cashing companies.

Finally, there is evidence of what has been termed "fictive friendships" in some of these transactions. Rent- to- own companies claim to treat individuals with dignity and respect, and finance companies claim that "People come to us because we treat them like an important person"[111]. Michael Hudson quotes the owner of a Rent-to -Own chain describing his top manager as a person who "doesn't rent televisions. He doesn't rent washers ...He doesn't sell anything. He develops *relationships* with people".[112] Economic relationships are partly embedded in social relationships between supplier and consumer with the goal from the supplier's perspective being to prevent the consumer from seeking alternative credit sources.[113] It is a mirror of the "relationship banking" that mainstream financial institutions offer upper income consumers and the alternative sphere may feed on the traditionally more distant role of financial institutions in their dealings with lower income individuals. It may differ from relationship banking however in the greater power that the supplier in the alternative sector may be able to exercise over the consumer. Informality and flexibility are hallmarks of these forms of lending and this suggests that the design of any alternative to attract individuals away from using these institutions should pay close attention to this aspect if it is to be successful.

III: Rationales and Explanations for Regulation

Conventional accounts of consumer regulation emphasise three objectives: the correction of market failures, ethical goals such as distributive justice (including risk and loss spreading), and paternalism.[114] It is probably correct to state that the development of consumer protection since the late 60s has reflected an inchoate distributional motive that there should be a redistribution of power and resources (such as rights) from producers to consumers. A continuing theme, at least since the publication of David Caplovitz' *The Poor Pay More* has been the role of consumer protection in protecting the disadvantaged and alleviating problems associated with low income. In Canada this latter theme may be found clearly in early documents on consumer credit protection such as the *Report on Consumer Credit of the Special Joint Committee of the Senate and the House of Commons on Consumer Credit and Cost of Living*.[115]

1. Traditional neo- classical economic framework[116]

The primary economic rationale for consumer protection regulation is that of market failure. In the context of consumers' economic interests two central potential failures are those of market power and information failure. Both these failures are relevant to the alternative financial sector. In relation to market power there is some evidence that within certain urban neighborhoods firms may be able to exercise a modest monopoly power because of high transportation costs and habit and convenience which deter individuals from shopping outside their neighborhood.[117]

Information asymmetry between suppliers and consumers is relevant to all consumer credit markets and is a reason for the existence of regulation such as truth in lending and control of credit terms. There are therefore "standard" economic reasons for regulating information disparities in the alternative financial sector which apply to all consumer markets.

Caplovitz argued that there was a prevalence of fraud and deception in lower income markets. This may be partly explained by the lower levels of information and monitoring in these markets. There may be less reliable third party information on shopping alternatives (e.g. consumer reports, media review), individuals may face higher search costs and there is less monitoring of these markets by the media and governments. Lower income individuals may also have greater difficulties in enforcing their rights and may have fewer social and professional contacts to turn to in the event of problems. There will be therefore private law failures in terms of ensuring market performance. There is also the question of how "fictive friendships" between suppliers and consumers may operate in these markets to inhibit consumers from seeking cheaper sources of credit and create relationships of dependence.

There may also be externalities (third party effects not priced in the debtor/creditor agreement). Overindebtedness and debt default may affect an individual's health and work performance, be connected with marital violence and breakdown, and require state subsidised services such as credit counselling or the provision of social assistance.

The market failure approach is based on the normative goal of consumer sovereignty so that consumer policy is concerned with ensuring that the market should operate effectively to satisfy the preferences of the informed consumer in a competitive market. Since in practice most markets will exhibit some failure this approach also counsels that the costs of regulation should be balanced against

its benefits and that policy making should analyse sequentially the least to the most "interventionist' policy. One important modification here is the assessment of welfare losses in cost/benefit analysis. Traditional analysis assumed that a dollar was valued the same by a rich person as by a poor person. This fails to take into account issues of diminishing marginal utility of money and the Office of Fair Trading has argued that in any use of cost benefit analysis the losses to lower income consumers should be weighted to take into account the fact that the an extra 10 dollars paid by a person earning 100 dollars a week will result in higher welfare losses than an extra 10 dollars paid by a person earning 1000 dollars a week[118].

A second ground for protection is based on distributional grounds: that individuals are paying too much for services in these markets compared to consumers in middle income markets and that this is unfair. Interest rate ceilings for example are one attempt to ensure that individuals do not pay what are regarded as exploitative rates for credit. Traditional neoclassical approaches to consumer protection envisage little redistributive role for consumer protection. There are several reasons which are put forward for this position. First, there is the futility argument. This argues that so long as individuals remain free to contract businesses will pass along the increased costs of any redistributive measure to consumers and that if businesses are prevented from doing so, then they may be unwilling to deal with consumers. In the context of credit markets this could mean that regulation of the price of low income credit might lead to suppliers being unwilling to continue to provide the service. As a consequence individual consumers might be forced to use illegal forms of lending such as loan sharks. The traditional approach argues that the more effective and fair method of addressing the problems of lower income individuals is through the tax and transfer system which would address directly what is perceived as the basic problem --- insufficiency of resources--- and not place the burdens of redistribution solely on those who supply services to lower income consumers.[119]

Roy Goode, an eminent authority on consumer credit law summarizes this approach:

> Consumer credit legislation, though often associated with the protection of the indigent, is in truth neither designed nor equipped for the special needs of the low-income consumer. There is nothing that consumer credit legislation can do to provide the consumer with a good job, a reasonable income or a roof over his head...These are questions of social welfare which are the responsibility of government.[120]

The above argument will be familiar to many readers since it is a standard argument in policy debates over such issues as credit card interest rate ceilings[121], restrictions on creditors remedies and other contractual terms, the control of tax rebate discounting[122], and many other consumer protection measures. There are however several limitations to this approach. First, all laws have distributional impact in advantaging or disadvantaging particular individuals or groups. The extent to which any advantage will be undercut by market forces is an empirical question depending on the conditions of the particular market. The futility of redistribution thesis is sometimes stated as an abstract position without much serious investigation of the nature of particular markets. When these are studied the potential detrimental effects may be much more modest and need to be balanced carefully against the benefits of the legislation[123] and in the light of other social values which might be furthered by the regulation.

Second, there is the reality that the tax and transfer system is increasingly under pressure and that there must be concern about progressive measures of redistribution being undercut by a regressive credit system, where credit is being used to purchase the necessaries of life.

Third, tax and transfer redistributions may give rise to similar side effects to those attributed above to consumer protection measures.

Fourth, the traditional approach neglects the extent to which existing market structures are distributional in the sense of conferring bargaining power on different market actors. "Unregulated markets" do not exist because all markets have ground rules of property and contract which specify the extent to which individuals are able to take advantage of others in the market. A regime which permitted insider trading would be efficient in the technical sense of achieving a market equilibrium but might have significantly different distributional consequences from a regime where such trading was prohibited. Recognition of this point undercuts the traditional language of "government intervention" because government is always present in distributing the ground rules of the market whether through the common law or statutory regulation. The comparison must be between two systems of regulation and distributional issues are an important aspect of the comparison.

Fifth, there are significant problems in applying cost/ benefit analysis in the traditional model.[124] Since individuals tend to value more highly something which they already possess rather than something which they do not currently have (known as the endowment effect) this creates problems for assessing costs and benefits. For example, individuals in the UK have comprehensive statutory protection in relation to credit card companies and connected lending.[125] Canadian consumers have no statutory protection. It is possible that UK consumers might demand a higher price to give up these rights than Canadian consumers would be willing to pay to obtain the protection. However, a change in the legal rule might change individuals attitudes to the value of protection, resulting in a higher valuation after the change. A response to this critique is to argue that it may be prudent to give a weighting advantage to the status quo. This is a more controversial principle since it appears to be applied rather selectively by economists. Rent controls and usury ceilings, which have a long history, are often not given this weighting by economists. Finally, there is increasing interest in alternative and/or complementary mechanisms to the tax and transfer system to redistribute resources and address problems of inequality in contemporary society.[126]

These criticisms do not mean that one should not weigh carefully the economic consequences of consumer protection policies in terms of their impacts on market choices and prices. They do undercut the position that distributional goals such as equality of treatment, fairness and redistribution of rights and resources are not valid objectives of consumer regulation. Distributive goals should not merely be associated with the idea of an income transfer but include such issues as the provision of greater security and autonomy to consumers in their dealings with business.

Paternalism is a slippery rationale for regulation because it is often difficult to distinguish situations where governments are responding to problems which prevent individuals from reaching a rational judgment and those where government is overruling individual's judgments and substituting its own judgment. The topic of paternalism is best understood in the light of bounded rationality, the topic of the next section.

2. Bounded rationality, cognitive distortions and market manipulation

During the past thirty years psychologists and some economists have developed a large body of knowledge which questions the assumption of expected utility theory that individuals are rational maximisers of expected utility.[127] The idea of "rationality" in expected utility theory assumes that individuals have perfect information processing capacities in relation to available information and that the choices which they make do not differ depending on how an issue is framed . The experimental research has suggested however that individual decision making deviates systematically from this model. In this paper I will highlight those findings which are of particular relevance to consumer protection and the problems of vulnerable consumers. These include the findings that individuals are poor statisticians, deviate significantly from the model of discounting suggested by economic models of intertemporal decision making, and exhibit time-inconsistent preferences.

Consumers must often make intertemporal decisions in relation to consumption. Should I save now and consume later? Should I borrow now or later? Should I buy the cheaper refrigerator with the higher operating costs or the high priced energy efficient model ? In many decisions costs and benefits are spread out over time. Economic analysis assumed that rational individuals making decisions about whether to receive money now or later would (at the margin) discount money streams at the market rate of interest. In addition it was assumed that individuals' discount rate would be consistent over time. Both of these assumptions appear now to be "importantly wrong"[128]. Some examples from the large literature on this topic may illustrate when individuals appear to be willing to pay extraordinarily high discount rates.

An experiment asks individuals to imagine that they had won the lottery[129]. They were then asked how much they would need to be paid to make waiting for the lottery winnings attractive as contrasted with immediate payment. Three strong patterns emerged.

First, discount rates declined sharply with the length of time to be waited. Individuals were willing to pay a higher discount rate to receive cash within a short period of time.

Second, discount rates varied with the amount at stake. They were willing to pay higher amounts in relation to small amounts(under $100). Loewenstein and Thaler describe this as the magnitude effect and argue that this suggests that individuals are interested in the absolute differences between money amounts rather than relative differences. Thus individuals appear more willing to wait for $150 in one year rather than receive $100 now, than wait for $15 dollars in one year rather than $10 now. They also suggest that this difference may be explained by different methods of mental accounting. Small windfalls are checked into the consumption account (for consuming) and larger amounts into a mental savings account. The cost of waiting for a small amount is viewed as foregone consumption whereas the cost of waiting for the larger amount is simply foregone interest. "If foregone consumption is more tempting than foregone interest, then the smaller amount will be taken now for immediate consumption."[130]

Third, the individuals in the lottery were willing to pay a higher reward to advance a gain than they were to delay a loss. These findings have been replicated in other studies and Caskey argues that these factors help to explain the discretionary use of rent-to-own, check cashing companies and tax rebate discounters:

In fringe banking transactions the customers pay a small absolute amount of money, but a relatively large percentage of the reward, to obtain the reward (cash) immediately. Since all three experimental findings are here—the length of time to be waited is short, the reward is relatively small, and the reward is positive-----one would expect customers to be willing to pay a very high implicit or explicit interest rate, and they do.[131]

A further finding is that individuals appear to have time-inconsistent preferences. This means for example that "when presented a choice between doing seven hours of an unpleasant activity on April 1 versus eight hours on April 15, if asked on February 1 virtually all would prefer the seven hours on April 1. But come April 1, given the same choice most of us are apt to put off the work until April 15[132]." Individuals are also poor statisticians. In making decisions about future uncertain events they tend to focus on more vivid evidence than statistical data (e.g. dramatic stories by our neighbours about a lemon automobile will outweigh our knowledge from Consumer Reports)[133] and are unduly optimistic about their own susceptibility to risks even when they know the actuarial risks.

The intertemporal variation in preferences which individuals exhibit in these experiments suggest that individuals may wish to protect their later more 'rational" self against their earlier less rational decision making. There are many commonplace examples of this "hands tying" strategy such as automatic transfers to savings accounts, diet clinics that prevent exit, Christmas clubs and so on. Public pension plans were partly justified on this ground. In the context of payday loans, a major concern has been that individuals who need such loans may have difficulties in paying off the initial loan and may become enmeshed in a spiral of increasing debt. This seems a strong justification for the existence of compulsory "hands tying" through controls on the rollover of loans and default charges.

One response to these findings on bounded rationality is that these deviations will be driven out through repeated market trading and through consumers learning from their mistakes The answer from the empirical studies seems to be that in some cases learning effects may be slight and that individuals may persist in making suboptimal decisions. These tendencies appear to be relatively resistant to "debiasing interventions"[134] a fact particularly relevant to discussion of consumer information policies (see below). A second response is that individuals and firms will not survive in the market if they continue to make these mistakes. This argument may have greater weight in relation to firms rather than individuals. Individuals may continue to make mistakes but this will not necessarily lead to bankruptcy. As Conlisk comments " We commonly read in the financial pages that firms fail for lack of profits but we seldom read in the obituary pages that people die of suboptimization".[135] One economic assumption in consumer protection has been that there is less need for protection in small repeat transactions because consumers will learn from their initial mistakes. But the above evidence indicates that we might question this assumption.

In a recent article in the *Harvard Law Review*[136], Jon Hanson and Douglas Kysar, after documenting a number of these instances of bounded rationality, argue that firms exploit these irrationalities and that there is a new market failure, that of *market manipulation.* This does not mean that there is necessarily any conscious manipulation but that if firms are to survive they adapt to these strategies. The authors provide a veritable cornucopia of marketing techniques which exploit the "irrationalities" identified by psychological research. One example is the influence of one of the most robust findings of the literature-- that of the framing effect[137]. This refers to the fact that individuals make different decisions in relation to the same issue depending on how that issue is framed. Choices framed as forgoing a gain will often be chosen over those framed as accepting a loss. Thus it is argued that consumers react differently to the labelling of differences between two prices as a surcharge rather

than a discount. Prices for credit card purchases framed as a surcharge are likely to result in fewer credit sales than when prices are framed as a discount for cash. It is not surprising that credit card companies insist that any price difference should be labeled a cash discount rather than a credit surcharge.[138]

The possibility of market manipulation coupled with the findings of the behavioural studies have several consequences for understanding the regulation of consumer credit .

First, the traditional neoclassical approach was based on the assumption of consumer sovereignty and a distrust of paternalism. A commonplace argument is that if individuals are freely making choices in a market then it is not the role of government to paternalistically protect them against making "foolish" choices. Provided consumers have adequate information and there are no other market failures, then there is no reason to intervene in the market. The literature on bounded rationality suggests that this is an overly simple dichotomy given the systematic failures of consumers to act in a rational manner.

Second, it undermines the argument that the poor are in some way incapable of making rational decisions (market irrationality) compared with the rest of the population.

Third, it suggests that we look more closely at traditional techniques for protecting consumers. If information policies in consumer credit are based on a rational model of decision making, then it is not surprising that some writers have questioned the efficacy of such disclosures. Information policies are a form of "debiasing intervention". The market manipulation thesis implies that it may be difficult to change consumer perceptions solely based on the provision of information. This may be particularly true for consumers who are in need of immediate credit and who may therefore be susceptible to these techniques.

There are also studies on the relationship between the concept of interdependent utilities and the propensity to save and consume among different classes. Robert Frank has argued that the many studies which indicate that higher income consumers save more than lower income consumers may be explained by the nature of consumption goods. Thus there is a distinction between positional goods and non positional goods. The former are those which are readily observable by others such as cars or automobiles, the latter those which are not observable, such as savings and insurance policies. He argued that the demand for non positional v positional goods rises with income and the accumulation of positional goods. This argument accounted for the greater levels of savings to income among higher income households.[139]

3. Equity and distributive justice

(1) Fairness

Research suggests that individuals do care about fairness in the market place and that this cannot be reduced solely to self-interest.[140] Experiments indicate that individuals are unwilling to trade with exploitative businesses even at some sacrifice to themselves. Media exposés of usurious interest rates tend to be discounted by economists who view them as sensational and who note that, in the cool light of economic analysis, the interest rates simply reflect the high risks of these markets. This seems to mistake the fact that many individuals do consider it wrong that lower income and disadvantaged individuals should pay much higher rates than middle income consumers—and will persist in this opinion even in the

face of the economic explanation. Many individuals would view higher credit prices paid for necessities by lower income consumers as a regressive form of taxation.[141]

The regulation of fraud and fair dealing may be seen also as part of the establishment of community values. Judicial analysis of unconscionability explicitly refers to the concept of community values. This recognises that consumer protection law has a symbolic significance in influencing social norms and business culture. Economists are beginning to study more closely this role of law and the relationship between legal and social norms in markets.[142]

(2) Financial Exclusion

The concept of "social exclusion" has become influential in recent years. It is wider than the concept of poverty which is sometimes associated with the concept of material resources. Social exclusion "is a broader concept than poverty, encompassing not only low material means but the inability to participate effectively in economic, social, political, and cultural life, and, in some characterizations, alienation and distance from the mainstream society".[143] This concept of being "shut out" of the social rights of citizenship is a theme in recent discussions of the topic of financial exclusion. The Consumers Association of Canada refer to "the important role of financial services in affording individuals with the basic services they need to participate in most aspects of public life, analogous to other public utilities.[144]" The Financial Services White Paper also connects financial exclusion to citizenship and equality of opportunity:

> "promoting equitable access for the less well off, for seniors and for people with disabilities is an important public policy objective [and] ensuring that all Canadians have access to basic financial services is an issue of fundamental significance to the government... Without an account to make electronic payments or write cheques, an individuals ability to participate in the economic mainstream is restricted ." [145]

(3) Consumer protection and "positive welfare"

Some writers have viewed the goals of modern consumer protection as connected to the values of the welfare state such as the provision of security against unforeseen circumstances, limiting risks to which individuals are exposed , and spreading losses suffered by individuals among all consumers. Many provisions of consumer credit law may be viewed in this light such as restrictions on seizure and sale, liability for lost and stolen credit cards, connected lender liability, and the ability to declare personal bankruptcy. The role of the welfare state is being rethought in many countries. Anthony Giddens has argued that we should rethink approaches to risk in the welfare state based on a model of "positive welfare".[146] This recognizes that welfare policy must combine a mix of approaches which are not merely reactive but which attempt to address all facets of a problem. This might involve educational, regulatory and material components. This would go beyond a view of welfare as solely that of income transfers. The relevance of Giddens' analysis is that the issue of access to credit for vulnerable consumers is one to which there must be a mixture of approaches which combine regulation, education, and institutional initiatives which expand choices for consumers. The credit and the financial system have often been harnessed to achieve public goals such as educational opportunity (student loans), home ownership, and regional development. Without passing judgment on the merits of these individual initiatives it is hardly novel to suggest that the system be viewed in terms of social objectives beyond solely market allocation.

4. Explanations of existing patterns of regulation of low income markets

Both economists and political scientists have developed theories to explain existing patterns of consumer regulation and its enforcement as responses to interest group pressures. An initial position was that because consumers are a diffuse, fragmented group and producers tend to be more concentrated, consumers would face difficulties in ensuring effective regulation. In addition, it was argued that although consumers might succeed in obtaining legislation where the media highlighted an issue (and acted therefore as a surrogate for political demand), legislation might be merely symbolic, or its effects cut down in the low visibility of day to day enforcement.[147] Consumer groups might lack the resources to monitor day to day enforcement and the media would move on to another issue. A variation of this argument was that enforcement might be more responsive to issues raised by more articulate external constituencies, which relates to the more general question whether the benefits of consumer protection have accrued mainly to middle class or more affluent consumers. On this issue of the distribution of the benefits of consumer protection two US findings in relation to fringe banking and the alternative financial sector are relevant. First, there is the argument that sectors of this industry are increasingly powerful in lobbying for industry-friendly legislation. Second, Caskey concluded that insufficient resources were devoted to regulating and monitoring fringe banking markets compared with those markets and institutions serving middle class consumers[148].

It is difficult to assess Caskey's arguments in relation to enforcement because much enforcement activity in Canada is not reported or not reported adequately in public documents. It is necessary also to have some normative theory of optimal enforcement since common characteristics of regulation of consumer markets are overinclusive standards and the delegation of enforcement to a bureaucracy with limited resources which must exercise discretion in identifying enforcement targets[149]. While there are no systematic studies which have assessed the enforcement of consumer protection legislation, it is well known that most provincial governments have reduced resources committed to enforcement of consumer protection legislation. Some writers have argued that the Tax Rebate Discounting Act is not enforced strongly and many pawnbrokers in Canada probably violate the usury provisions of the Criminal Code, but there appear to be few prosecutions under this section. On the other hand there are a sprinkling of cases involving the prosecution of loan brokers. Given the reduction in resources assigned to consumer protection, enforcement is likely to be reactive to external information and to the media.

The problems of lower income consumers appear to have a relatively low visibility in the mainstream media in Canada. Apart from the issue of bank closings, which is not solely a lower income issue, there is little sustained analysis of the alternative financial sector in the mainstream Canadian media. This contrasts with the US where the topic of payday loans and subprime lending have been discussed in both the *Wall Street Journal* and the *New York Times*. This lack of media coverage means that there may be little public knowledge of the problems of low income and marginalised consumers.

IV: Assessment of Existing Legal Framework

1. General Issues

(1) Federal/Provincial jurisdiction

The topics covered by this paper fall within regulation of consumer credit and financial services. Regulation of consumer credit is an area of both Federal and Provincial jurisdiction. The Federal government has exclusive jurisdiction over banking, interest, negotiable instruments, and bankruptcy and insolvency, while the provinces exercise jurisdiction over property and civil rights. This means, for example, that there are separate disclosure regimes contained in Federal bank legislation and Provincial statutes applicable to non-federally regulated financial institutions. There is recognition of concurrent jurisdiction in relation to the power of both levels of government to regulate interest rates. Given the possibility of either a narrow or broad interpretation of interest,("accruing from day to day" or the broader "cost of money" concept), the courts have acted pragmatically in refraining from striking down either Provincial or Federal legislation in this area. Mary Anne Waldron concludes that "while the Federal government was given the exclusive power to legislate on interest in the constitution, the provincial legislatures have been permitted by the courts to carve out a significant and, perhaps, widening sphere of jurisdiction"[150].

Although the history of Federal/Provincial cooperation in the area of consumer credit is not a happy one,[151] the current approach appears to be one of intergovernmental consultation and cooperation. The creation of the Consumer Measures Committee and the process of harmonization with which it is entrusted may be a useful method of providing coordination of provincial and Federal regulation.

Regulation of financial services is also divided between the Federal and Provincial governments with federal regulation of banks and federally incorporated trust and loan companies and insurance companies, and provincial jurisdiction over institutions such as credit unions, and provincially incorporated insurance companies and trust and loan companies. In the recent White paper on reform of the Financial Services sector, the Department of Finance proposed the creation of both a Federal Financial Consumer Agency (reporting to the Minister of Finance) and a Financial Services Ombudsman. The former is of particular relevance to this paper since its objectives include increasing consumer financial literacy , monitoring industry initiatives in relation to issues of access, and consulting with consumers and financial institutions.[152] The Financial Services White Paper proposed a functional approach to consumer protection noting that it believed that the "fundamental interests and needs of consumers do not vary from jurisdiction to jurisdiction".[153]

The normative question in this area is-- what is the most appropriate mix of Federal and Provincial initiatives in terms of maximising benefits to vulnerable groups? The evidence in relation to the alternative financial sector indicates that, while there may be provincial variations in the extent of particular practices, they are also national in scope. There may be economies of scale therefore in a centralized monitoring and information gathering role and in cooperative enforcement. The industries are comprised of both national firms and small local suppliers which has implications for enforcement costs. For example, to the extent that there are significant numbers of small operators and, given the relative ease of entry and exit to markets such as cheque cashing, loan brokering and tax rebate discounting, local authorities may have a comparative advantage in terms of enforcement costs. Local enforcement agencies are likely to be more responsive to local consumer and business interests and to the local media which may affect priorities for action. The description of an initiative as local should not

necessarily be equated with provincial jurisdiction. The Federal government may operate decentralised programmes and municipal governments often may play an important role in the regulation of issues affecting vulnerable groups of the population (e.g. regulation of pawnbrokers).

(2) The Form of consumer protection legislation in relation to vulnerable consumers

An important question in the design of legislation is the extent to which it is formulated as detailed rules or as more general standards. An example of the former are detailed disclosure requirements, while the latter are exemplified by the broad standards of unconscionability doctrine. There is much evidence that a high level of specificity is desirable in relation to consumer credit protections and particularly those which impact most on vulnerable consumers. Vague, open textured standards such as unconscionability or "commercial unreasonableness" inevitably give rise to a variety of interpretations and depend heavily on all the circumstances of individual transactions. It may always be possible to argue in an individual situation that a transaction is unconscionable but it is unlikely that unconscionability provisions will have much impact on the general run of transactions.[154] To the extent that their use depends on individuals bringing actions to determine the applicability of the provisions to their situation, our knowledge of consumers' willingness to litigate suggest that few actions will be brought and that they do little to augment consumers' bargaining power with suppliers. Even where such provisions may be enforced by public agencies, they have shown little enthusiasm for testing the boundaries of unconscionability legislation.

One modification to the use of specific provisions may be to include within specific legislation a statement of its overall purpose and a general anti-avoidance provision. For example, debt collection legislation might prevent collectors from calling after 8.00 pm at night and before 9.00 am. There is the need for a provision which protects an individual who works on night shifts from being harassed at 11.00 am by a debt collector who is aware of her work patterns.

One characteristic of the practices considered in this paper is that of structuring transactions to avoid existing legislation. The courts have indicated on a number of occasions that consumer protection should be given a broad and liberal construction,[155] and, in relation to Section 347 of the Criminal Code that substance should triumph over form.[156] It may be useful to include a clause to this effect in future credit legislation.

(3) Enforcement issues

Assessment of the form of legislation should take into account issues of enforcement in relation to the alternative financial sector. A number of industries within this sector have large numbers of small firms with some national chains. Smaller firms are likely to have lower levels of compliance, particularly if there are low entry and exit costs to an industry. Since few consumers are likely to complain to third parties, there may be a justification for increased monitoring of smaller firms and greater publicity given to prosecutions. Given the costs of obtaining information for a successful prosecution, there are strong arguments in favour of bright line rules to reduce enforcement costs. There is a general problem however that the small scale of many of the transactions may lead to a reluctance among prosecutors to be enthusiastic about criminal prosecutions and the judiciary unwilling to levy heavy sanctions. These factors may turn the apparently strong criminal sanction into something of a paper tiger. It may be that precise rules which indicate a clear sanction, such as non-recovery on the part of the supplier[157], should be adopted, in addition to the use of the criminal sanction.

2. Common law doctrines and private law remedies

The common law of fraud, deception and unconscionability are a form of regulation but there is widespread agreement that common law doctrines have not played a significant role in the protection of vulnerable consumers. Common law doctrines are often open- textured so that there will often be uncertainty as to their application to particular circumstances. Given the small monetary amount at stake in transactions such as payday loans, and rent to own , it is unlikely that any individuals will be willing to litigate. The existence of class actions may reduce this barrier where there are bright line rules which affect all the class in a similar manner.

The doctrine of unconscionability in Canada has two formulations. The first approach requires that there be both unfair terms and inequality of bargaining power. The second is a broader formulation which asks whether the transaction "seen as a whole, is sufficiently divergent from community standards of commercial morality that it should be rescinded".[158] This latter formulation underlined the symbolic role of doctrines such as unconscionability in expressing social disapproval of particular practices.

All provinces have enacted statutes controlling unconscionable lending but these statutes have not generally been interpreted differently from the common law interpretation of unconscionability[159]. An apparently unconscionable price will not on its own permit the court to set aside the loan but the court will look at all the circumstances of the case including the bargaining position of the borrower. There are few cases brought by individual consumers under these statutes.

3. Trade Practices Legislation

These Acts were introduced in several provinces in the early 1970s and are now in force in almost all provinces. They are potentially a source of regulation of various aspects of practices of the alternative financial sector. Most statutes contain shopping lists of both deceptive and unconscionable practices and several sections of these acts , for example those relating to "grossly excessive price[160]", "no reasonable probability of payment in full" , "consumer not reasonably able to protect his or her interests" and "failure to state a material fact", could be used in relation to the alternative financial sector. The Acts also confer on public agencies a number of wide ranging administrative powers and remedies (cease and desist etc) as well as criminal remedies. These statutes have three main objectives: (1) Assuring higher compliance than was achieved through private law by the use of administrative remedies (2) reducing consumer enforcement costs through changes to legal doctrines and (3) the potential for innovative development of norms related to consumer markets by a specialised agency which could bring continuity and expertise to the development of policy . It is not possible within the scope of this paper to assess the experience of the Trade Practices Acts and their distributional impact. However, it is perhaps fair to state that they have, with some major exceptions, not been the source of innovative norm development such as the development of good faith in consumer relationships.[161] Questions have been raised as to the effectiveness of enforcement of these Acts, a difficult issue to measure in Canada, since much enforcement activity is not reported. The private remedies under the Acts appear to have been used primarily by consumers who have purchased automobiles and are used as an alternative to the Sale of Goods Act to rescind the contract or obtain damages. One writer has suggested that more affluent consumers have been the main beneficiaries of the private remedies under similar statutes in the US.[162]

4. Information policies

Information disclosure has been a central policy in protecting consumers in the credit market. In particular the concept of standardized disclosures of the price of credit in dollars and as a percentage calculation (APR) are central aspects of consumer protection. The objectives of these provisions are to facilitate shopping for credit by reducing consumer search costs, stimulating competition and preventing unfair competition. Disclosure may also have a warning or alert function in drawing attention to aberrational rates or particularly high sources of the costs of credit.[163] Other goals of truth in lending include the provision of a "contract synopsis" in a standardized manner of the central terms of the transaction and the prevention of market discrimination.[164] Surveys of the impact of truth in lending suggest that while knowledge of the APR has increased, consumers are not always able to use it to calculate finance charges and are not always aware of the total dollar amount of the cost of borrowing. However, consumers do seem to be aware in general of which sources of credit are more expensive and have a high degree of awareness of the monthly payments required. These findings were based primarily on US studies in the 70s. Later studies in England indicate a higher awareness over time of the role of APRs in credit decision making with differences in knowledge correlating with education and income.[165]

Much of disclosure legislation in the area of consumer credit is based on a rational choice model of consumer behaviour. There is the assumption that consumers who are armed with the relevant information ought to make the right purchasing decision, i.e. one which will maximise their expected utility. This is a normative model of how consumers ought to behave.[166] However, the research on bounded rationality suggests that consumers often deviate from this model and are particularly likely to do so in the case of small loans over a short period. As a consequence the provision of an APR may have two possible effects. Either it will have little impact or it will have too much impact. The latter scenario might relate to where a consumer has a limited choice of using a payday loan or writing a cheque which might bounce. The payday loan might be the more rational alternative in this scenario but a consumer might be unwilling to use the payday loan for an interest rate of 200 percent.

The APR is most significant on long term loans such as mortgages, and substantial differences in APR may have only a modest impact on the repayment costs in relation to short term loans. The Office of Fair Trading in the UK use this argument to conclude that the APR should not be required on small loans for a short time period. They use the example of pawnbrokers, which are exempt from the UK APR credit disclosure provisions. In their view the APR "is of little relevance to consumers taking out small loans. An interesting example is provided by pawnbrokers, which are essentially finance shops...As a result of their business method, overhead costs are relatively high in relation to the amounts borrowed and the interest rates are not really comparable with those of mainstream lenders."[167] Geraint Howells, on the other hand, argues that disclosure is justified as a warning that these small loans are expensive.[168]

The above comments suggest that careful thought be given both to the content and form of disclosure in relation to the forms of selling and lending discussed in this paper. The devil is indeed in the details. One might imagine the following tag on a rent-to-own good:

YOU ARE RENTING THIS PROPERTY.
IF YOU WANT TO BUY IT, SHOP AROUND.
THE TOTAL COST WILL BE CHEAPER ELSEWHERE.[169]

Economists have suggested that the most effective method of reducing consumer search costs may be through the provision of comparative price and term information rather than through transaction specific disclosure[170]. Given the difficulties consumers face in processing information on costs, a neutral

third party intermediary could substantially reduce these costs . A rent-to-own consumer might find Table 5 of even greater use than the large print disclosure above. Encouragement should be given to neutral intermediaries such as the OCA to provide further comparative information in this area. Community groups might be consulted on the most effective form of information disclosure and might provide a useful conduit for information. Given the public good nature of information there may be good reasons for subsidising the production of this information.

Writers have drawn attention to the fact that the real value of information disclosure may be in disclosures relating to events occurring after the contract has been entered into[171]. Thus the contract can be a vehicle for incorporating legislative requirements and appraising consumers of their rights and obligations. Caskey argues, for example, that pawnbrokers should be required to post a toll-free consumer complaint telephone number and print this information on the ticket.[172] This form of disclosure which incorporates consumer rights into the contract reduces the scope for misunderstanding and disputes between consumer and supplier, providing almost a 'self-enforcing" form of regulation.

5. Controlling Terms

Most consumer credit legislation controls default terms and seizure and sale practices in credit transactions. There are economic reasons for controlling such terms based on bounded rationality and information failure. The Model Deferred Deposit Loan Act in Appendix 1, for example, limits charges by payday loan companies for cheques with insufficient funds. Some economic analysis hypothesizes that draconian terms such as high late payment fees may be necessary as a means for sellers to serve high risk consumers[173] and presumably that prohibiting such charges would lead to cross subsidisation by good payers of bad payers, or worse, the withdrawal of suppliers from the market. Empirical analysis suggests that the effects of restrictions on remedies on credit granting are likely to be modest[174] and that creditors already have adequate remedies in the event of default. Given the vulnerability of the consumers in this market, there can be little objection to the establishment of a reasonable limit on such charges as part of the total cost of credit.

6. Controlling Terms: Interest Rate Ceilings

Interest rate ceilings on credit have a long history and continue to exist in many countries throughout the world[175]. They are "among the oldest and most prevalent form of economic regulation[176]" The only current general control on interest rates in Canada is section 347 of the Criminal Code which creates a criminal interest rate of 60 per cent. A central objective of interest rate ceilings has been the provision of access to credit for ordinary individuals at reasonable terms. This was the main objective of the now repealed Federal Small Loans Act (see Appendix 2) which was structured to ensure that lenders obtained a reasonable rate of return while ensuring that small loans would be available at not unreasonable rates to lower income individuals. The current provision in the Criminal Code is not designed to achieve this objective but rather was intended to protect against grossly excessive rates.[177]

There is significant criticism of section 347. The section is overinclusive and strikes at many valid commercial loans, requiring businesses to restructure transactions. It does not appear to be actively enforced by public authorities. There have been a handful of prosecutions of pawnbrokers and no prosecutions of payday loan companies under this section. There may be a reluctance on the part of Crown attorneys to prosecute in these cases of economic crime where the individual amounts at stake may seem small and the perpetrator may themselves be a small business.[178] There is also the question which was raised in relation to disclosure of the APR, namely, whether s347 is an appropriate form of

regulation of small loans which are made over a relatively short period of time. The broad definition of interest in the section would include the fixed costs of administering such small loans, and would often result in a criminal rate. The exclusion of the Tax Rebate Discounting Act from the scope of section 347 recognised the need for a discrete regime for this type of loan.

There is disagreement as to the value of interest rate ceilings. Many economists believe that they are counterproductive because if they are set below the market rate they will limit consumer choice and lead to the creation of illegal markets where consumers pay a "crime premium". If on the other hand they are set above market rates then they will have no effect on market forces.[179] There may however often be a range of interest rates within a market (e.g. see Table on payday loans) and one role of interest rate ceilings may be to prevent excessive rates within the market. In addition, interest rates which are significantly higher than the general market level may also be a signal of fraud, deception or overreaching. These phenomena are difficult difficult to prove and the existence of bright-line interest rate ceilings reduces enforcement costs against deceptive businesses. Caskey in his discussion of cheque cashing companies argues for price controls which prevent companies from charging fees well above the average. In his view, if these ceilings were rigorously enforced it would prevent unscrupulous cheque cashers from exploiting unsophisticated consumers or those with little alternative sources of credit.[180] Price ceilings in the Tax Rebate Discounting Act are intended to achieve this objective.

There is a need for greater reflection on the role of interest rate ceilings. Since they may take several forms, such as a single rate, graduated ceilings as existed under the now repealed Federal *Small Loans Act* or different rate ceilings for different risk segments[181], it is dangerous to overgeneralize about their effects. If it is true that interest rate ceilings may prevent certain lower income individuals from obtaining credit then it is necessary to assess the magnitude of that effect. If many of these consumers were subject to bounded rationality as outlined earlier in the paper, then such restrictions might be regarded as desirable since information disclosure might not be an effective method of consumer protection against high risk credit. Even if ceilings excluded a minority of rational "risk takers" the prohibition might still be regarded as desirable in the light of other reasons such as the potential impact on the debtor's family in the event of default (externalities)[182]. If there was the expectation of some illegal informal lending as a consequence of the ceiling, then it would be necessary to provide some estimation of that illegal market and the possibility of effective enforcement.

The long history of interest rate ceilings has stimulated some economists to search more deeply for the rationales for interest rate ceilings. Eric Posner argues that the welfare system may create a problem of moral hazard with individuals being tempted to take on "too much" debt in the knowledge that they will be protected from the consequences of default by the welfare system. Interest rate ceilings deter individuals from doing so by limiting the extension of high risk credit to the poor.[183] Edward Glaeser and Jose Scheinkman argue that the best explanation of interest rate ceilings is as a rough form of social insurance. Individuals insure themselves against the possibility of income shocks and the necessity of borrowing in bad times by guaranteeing that interest rates will be low when they have to borrow. Their theory assumes that these individuals do not have other methods of insuring themselves. Glaeser and Scheinkam also predict that usury laws are stricter in periods of wealth inequality[184].

The above comments suggest that interest rate ceilings may play a role in consumer protection policy but that it is important to think through carefully both the objectives and the form of interest rate ceilings in relation to different markets. There is probably a convincing argument that may be made for using interest rate ceilings as a method of protecting against excessive rates but not as a means of second guessing normal market rates.

7. Licensing and other controls on entry

A common technique in Canada is for provincial legislation to establish industry specific legislation.. This will usually be a licensing regime, coupled with disclosure requirements, bonding, specific obligations, and a dispute settlement mechanism. A more recent development in some provinces is the encouragement of industry self-regulation and delegation of regulatory powers in "mature" industries to industry bodies[185].

Provincial legislation in Canada adopts two types of licensing in relation to professions related to the supply of credit. The most common form requires the supplier to meet a test of integrity and financial probity as a condition of obtaining a license and may also require a performance bond. Examples of this form of licensing include direct selling[186], motor vehicle dealers[187], moneylenders[188], credit reporting agencies[189], loan brokers[190], and collection agents[191]. Registration is a second technique which merely requires a firm engaged in a particular industry to register with the relevant Ministry, without the necessary pre screening in relation to integrity and financial probity. Tax rebate discounting represents this latter form with the discounter being required to register with Revenue Canada.

Licensing was argued as being important distributionally in the consumer credit field because it would protect those who are most vulnerable . The main advantages of licensing as a mechanism for attacking unfair trading practices are:(1) Since licensing is anticipatory it promotes prevention rather than cure. This is important where the costs of consumer detriment are high. (2) Licensing compensates for the potentially high information, monitoring and enforcement costs which individual consumers might face in relation to unfair trade practices. It can pool information about the market which can be used to screen out unfair traders. (3) Licensing may have a progressive distributional impact by benefitting those consumers least knowledgeable or able to assert their right and those most vulnerable to unscrupulous operators. (4) Licensing may create or stimulate consumer confidence in a market although it is difficult to measure the intangible value of this consumer confidence. (5) Licensing regimes can be used to provide valuable information on market practices for example the use of particular contract terms. It can provide a framework for continuing monitoring of marketplace practices, establishment of transaction standards, and complaint resolution schemes.(6) It can be used to "persuade" traders not to adopt practices which are regarded by many as undesirable but which are not unlawful.

There are some potential disadvantages with licensing regimes. (1) Unless unfair trading is endemic to a market, licensing is an overinclusive remedy since all operators in the market must be licensed.(2) There may be significant administrative costs associated with a licensing regime. (3) Licensing attacks unlicenced not unfair trading. This is not problematic if there is a close correlation between unlicenced and unfair trading. (4) The costs of licensing the whole market may draw resources away from a more finely tuned enforcement against unfair practices. (5) The costs and procedural constraints (requirements of administrative law) on assembling a licensing case may reduce its effectiveness as a deterrent to the fly by night trader . (6) Licensing may give a misleading signal of quality or reduce a consumers defences if suppliers are permitted to exploit the signal "government licensed". (7) The drastic nature of the licensing remedy which revokes an individuals privilege to trade, and the costs of assembling a licensing case, mean that it will only be used in the most egregious of cases. This suggests the need for a variety of sanctions within a regulatory regime. (8) The broad standards in licensing regimes may be valuable in screening out those who are obviously unfit to trade but may be less accurate in screening those who might potentially engage in unfair trading. (9) Courts may be unwilling to levy heavy fines for unlicenced trading so that marginal firms with low entry and exit costs and a low probability of detection by the limited resources of government will find it

economically worthwhile not to be licensed.(10) The licensing authority may be "captured" by the industry or segments of it so that the licensing regime becomes a method of furthering industry rather than consumer interest.

Negative licensing is an approach which is intended to avoid the costs of running a positive licensing scheme for the whole industry. Negative licensing permits trading in a market without the necessity of obtaining a licence in advance. Traders would only be affected by the controls if they behaved in a manner contrary to standards established in the legislation. They could be warned, or subject to prohibition from trading in the market. This is the technique used in relation to real estate brokers in the United Kingdom. The advantage of this model is that resources could be concentrated on unfair traders.

It is difficult to assess the efficacy of licensing in protecting more vulnerable credit consumers in Canada given the limited public data and empirical studies of consumer licensing regimes. The *ex ante* protection and the reduced cost of prosecuting unlicensed trading must be balanced against the fact that unscrupulous businesses are unlikely to become licensed. In addition, the reduction in resources committed to consumer protection raises the question of the ability of governments to use these regimes as an effective method of providing continuing and reliable public information on marketplace practices.

8. Bans

Bans might be justified in relation to practices which are associated with a high level of fraud (e.g. referral selling) or as a form of "hands tying". In any decision to ban a particular practice it would be prudent to estimate the extent of any informal market that would arise and also whether there were any alternative institutions which could be developed to substitute for the practice. Bans may be preferable to licensing if there are not sufficient resources to adequately fund the licensing process, and there are potentially high levels of consumer loss. Bans create a clear signal to producers and consumers and reduce enforcement costs in relation to the banned practices. One interesting role of bans may be to pressure existing institutions to meet consumers' needs. For example, it has been argued that the ban on charging a fee for cashing government cheques in Quebec created greater pressure on financial institutions to cash these cheques.

9. Human Rights Legislation

Human rights legislation has modified the common law rule which permitted individuals to decide arbitrarily with whom they would contract. There are two forms of discrimination recognised in Canadian law; direct and indirect. The former is the most straightforward and recognizes discrimination where two similarly situated individuals are treated unequally based on an irrelevant characteristic such as race. The latter form of discrimination is described as indirect discrimination, constructive discrimination or adverse impact discrimination[192]. This describes the situation where an institution uses facially neutral criteria which have an adverse impact on protected groups under Human Rights legislation. A recent example of relevance to credit allocation is the decision of an Ontario Human Rights tribunal that the use of 30 percent rent- to- income ratios as a screening device by landlords contravened the Ontario Human Rights Code, since this criterion had a disproportionately adverse impact on groups protected under the code such as single female parents, those on government

assistance, recent immigrants, and visible minorities.[193] The tribunal also found that the landlords failed to show that the use of the rent to income ratios was reasonable since they could not demonstrate that the use of a rent-to-income ratio reduces a landlord's incidence of default.

There are several points worth noting in relation to this decision. First, the case has significance for financial institutions which use credit scoring systems as screening devices for credit granting. The issue may be raised whether such apparently neutral systems may have an adverse impact on protected groups. Credit scoring is an apparently neutral method of legally discriminating among potential credit applicants. However, these screening devices may encode subtle discriminatory criteria such as stability of home ownership, which might discriminate against minority applicants who find it necessary to move frequently in order to progress economically. More generally, it has been argued that the characteristics regarded as desirable in credit scoring systems would be based on historical data, with a potentially built-in inertia against groups with differing but equally creditworthy applicants.[194] There is perhaps the belief that credit scoring systems are an objective method of assessing risk and thus the Office of Fair Trading comment that "in a competitive market it would be extremely difficult to discriminate systematically against individuals solely on the grounds of ethnic origin when assessing credit..risks. [Access to credit [is] calculated using increasingly sophisticated risk-assessment methods."[195] Yet the neutrality of credit scoring systems is clearly at issue in recent US discussions of the persistence of discrimination in areas such as mortgage lending . Lenders such as Fanny Mae which lend to lower income consumers have attempted to overcome some of the criticisms of these systems.

A second point which emerges from the *Kearney* case is the extent to which, notwithstanding the apparent objectivity of the rent to income ratios, landlords and their agents exercised considerable discretion in rental decisions since many individuals were in fact paying more than 30 per cent rent of their income on rent. Expert evidence was accepted at the tribunal that there were many myths about the poor or those on public assistance, for example, that they move a lot, are irresponsible in managing their money and are destructive tenants. These myths affect public attitudes towards the poor. The apparently neutral and objective rent- to- income criterion might often be used to justify discretionary decision making based on discriminatory stereotypes. This underlines the fact that addressing the problems of vulnerable consumers must of necessity address the way in which such groups are represented in society.

It is sometimes stated by spokespersons for financial institutions that they do not discriminate because they act on objective market criteria in determining questions of access and that they would be foolish to turn away creditworthy consumers. However, the issue is not quite as simple. It is quite possible that the upper level of bank management may be committed to serving poorer communities, partly because the public image of banks has taken such a battering in recent years. However, to the extent that there is significant discretion at branch levels, the type of general public attitudes evidenced by the *Kearney* case may still have an impact. Since all banks are likely to have similar policies and practices it is not clear that there will be competition around this issue or the possibility of new market entrants of any significant scale to take advantage of this market which is not being served[196].

Finally, the *Kearney* case encourages reflection on the place of economic discrimination within human rights models. Human rights legislation protects individuals not because they are poor but because they fall within a protected group under the Human Rights code. Poverty has not been traditionally equated with personal characteristics (but note Quebec Human Rights provisions) which are relatively immutable, a characteristic associated with human rights protection but the Canadian Human Rights Commission has raised the possibility of adding "social position" to the enumerated grounds in the Federal Human Rights Code.

There are limitations on a human rights approach towards issues of credit allocation. The disparate impact cases are relatively complex, involving large amounts of statistical analysis which is often in the private realm. In the US, the existence of the *Home Mortgage Disclosure Act* which requires financial institutions to collect data on the race of home borrowers, has permitted greater monitoring and enforcement against discrimination in mortgage lending. A Human Rights approach addresses only indirectly the problem of economic discrimination and inequality and may have the perverse effect of reinforcing arbitrary economic exclusion in relation to groups not protected by the code. Those groups excluded from the protection may feel that one must belong to a "special interest group" to obtain protection. Addressing inequality in consumption may require a base broader than that found in existing discrimination law. This perception has stimulated other strategies such as the modified affirmative action model of the US *Community Reinvestment Act* and conceptions of "community empowerment". This last approach emphasizes the declining opportunities and increasing insecurity of significant segments of the population and questions whether existing institutions will ever fully accommodate those who experience exclusion and discrimination. It proposes the development of local community-controlled institutions which would serve those who are currently excluded from mainstream society.

V: Expanding Choices

The previous section focused on regulation as a method of increasing informed decision making and protecting consumers against harmful practices. In this part I consider institutional developments which might reduce both the need to rely on high priced credit and the existence of financial exclusion as well as facilitating savings capacity among vulnerable consumers.

1. Lifeline banking

The White Paper on financial services proposes that banks should offer a standard low cost account which would provide 12 transactions for a nominal fee of $3.00 to $4.00 dollars a month. In order to ensure that consumers are aware of this option, banks will be required to post information about the standard account in every branch. It is hoped that, in conjunction with legislating access to bank accounts, these initiatives will encourage individuals who do not have bank accounts to move into the financial mainstream.[197] The White paper will also require major Federal deposit taking institutions to report on initiatives that they undertake to facilitate access for low-income individuals through annual Public Accountability statements. Banks must also provide four months notice of branch closures to customers and there is the possibility that the newly created Financial Consumer Agency may convene a consultation between the bank and community and consumer groups.

There may be queries as to the potential effectiveness of lifeline banking. First, it would be necessary to market it aggressively to overcome the image of banks among some groups. For example, some groups may be distrustful of banks because they perceive them to be intimidating or hostile to low income individuals[198]. The initiative might not be attractive to those who use cheque cashing outlets because of the convenience of their opening hours. It is not possible to cash a cheque at an ATM machine. Second, evidence suggests that there is significant discretion exercised by individual branches in the procedures for opening accounts and cashing cheques. A survey by testers of the implementation of the banks' voluntary code on cash chequing and opening a bank account indicated that some branches required individuals to make an appointment at a later date to open an account, while others indicated that a credit check would be required, and others placed a long hold periods on

government cheques[199].

While the upper management of banks may be committed to serving low income consumers it would appear that there is a monitoring problem within the banks in relation to the provision of access. This is a well known problem in relation to bureaucracies and it may be necessary to ensure that the incentives of front line workers ensure compliance. If, for example, bank employees are evaluated on the number of high value accounts which they can bring to a branch or the extra services (eg RRSPs) which they sell , then it will be difficult to ensure good service for lower income clients with small deposits and limited banking needs. There is also the issue of the impact of career incentives within banks on the willingness of employees to develop a knowledge of low income communities and other disadvantaged groups. It is probably true that one consequence of the US *Community Reinvestment Act* is that it has forced banks to develop this information and to think imaginatively about meeting the needs of disadvantaged groups. Even where the Act has failed in its immediate purpose, it has still been successful in requiring banks to think about their role in the community and in shaping public opinion on the contribution of banks.

The above comments are not intended to deny the value of lifeline banking. They do suggest however that it is not a panacea and careful attention needs to be given to its manner of implementation. At a minimum it suggests that bright line detailed rules in relation to such issues as the hold periods on cheques should be prominently displayed in branches and in other institutions. Disclosure within the branches is unlikely to have a large impact since the issue is to encourage individuals to enter the banks.

Edward Rubin has suggested more radical ideas such as permitting local supermarkets to act as bank branch locations or to be permitted to act as depositary institutions. The availability of such services might confer a significant competitive advantage and create incentives for offering such services at low profit margins[200].

2. Credit Unions

Credit Unions are provincially incorporated non-profit groups which are owned by the credit union members. They provide financial services for 33 per cent of the adult population.[201] The original goals of credit unions were to avoid problems of usury for lower income consumers and provide a mechanism for individuals to develop a savings capacity. There are currently 898 independent credit unions in English Canada with over 4.5 million members and assets of $49 billion. In Quebec the *Mouvement des Caisses Desjardins* operates the large network of *Caisses Populaires* with over 1300 branches throughout the province, assets of $71 billion and over 5 million members.[202]

There is significant variety among credit unions in English speaking Canada both in terms of size and organizational base. There are also regional variations with British Columbia having the largest credit union movement in English Canada[203], and Ontario possessing a much smaller movement. In some provinces credit unions are the only financial institution serving a community.

Table 7
Canadian Credit Union Statistics 1997

Province	Savings ($M)	Loans ($M)	Assets ($M)	Credit Unions	Locations	Members

BC	17858	17087	20444	96	330	1419314
Alberta	4327	3603	4734	85	178	449000
Sask.	5532	4307	6163	161	341	552, 285
Manitoba	4029	3553	4420	73	161	376000
Ontario	7831	6801	8543	327	628	1004798
New B'wick	433	396	488	27	34	77800
Nova Scotia	752	610	817	65	92	162351
PEI	259	228	293	10	13	48590
Newf/Labr	284	246	296	16	32	33893
Total	41782	37256	46718	873	1835	4178656

Source: *Credit Union Central of Canada* 1997 Annual Report

Some credit unions are open to the public, while others are organized around unions, companies or communities. Toronto, for example, has a large number of ethnically based credit unions. Each credit union has its own membership fee and lending policies established by its Board of Directors.

Many credit unions advertise themselves as alternative to "big banks"[204]. There are considerable variations between credit unions in their role in community economic development and their willingness to establish branches in low income urban areas. It was suggested to me that the requirement of a membership share of up to $50-75 made them unattractive to vulnerable consumers. There was also the observation that most credit union members are older individuals so there is a need to make them more attractive to younger individuals. It must be noted that although British Columbia has the highest percentage of credit union membership in English Canada, it also has the highest percentage of individuals without access to a financial institution and the highest per capita number of cheque cashing outlets.

The White Paper on Financial Services envisages a larger national role for credit unions as competitors to the banks but it is not clear whether such a move will be supported by the members of credit unions who may view this as creating pressures on credit unions to become similar to banks.

In Quebec the Mouvement Desjardins provides full service (banking, insurance, securities brokerage) financial services through the *Caisses Populaires*. It is the eighth largest financial institution in Canada , the largest private employer in Québec, a frequent partner with government in community economic development projects and has a social audit system which monitors issues concerning reinvestment in the community. It is argued that the large network of *caisses* throughout Québec and its more generous identification requirements have excluded fewer consumers. It is also argued that the prohibition on charging a fee for the cashing of government cheques has slowed the growth of cash chequing companies, creating greater demands from consumers that mainstream financial providers provide this service.[205]

3. Direct deposit[206]

The use of direct deposit of government cheques has implications for the provision of banking facilities for vulnerable consumers . Direct deposit requires an individual who relies on such cheques to have an account with a financial institution. There has been increasing use of direct deposit for government transfers and Alberta has adopted mandatory direct deposit for social welfare payments. Direct deposit creates bank incentives for the development and implementation of easily available forms of customer identification and account opening procedures and has potential benefits for both consumers and financial institutions.[207]

4. The Role of Community Institutions

There are many community institutions and groups throughout Canada which address issues of access to banking facilities.[208] One example is PEACH (Promoting Economic Action and Community Health), a community group in the Jane-Finch area of Toronto, which has worked with the banks to provide information on banking to the community and to sensitise banks to the problems faced by lower income consumers. It has had some success in reducing service refusals and its work contributed to the community receiving a "Caring Community Award". A key conclusion from this project is that it is necessary to develop community relations between bankers and community representatives before bank initiatives (policies, sensitivity training) are developed. The group acted as an "information intermediary" communicating issues concerning bank policies to the community. This may be an important aspect of effective information policies.

Another community action model is the Four Corners Community Savings, located in the downtown Eastside of Vancouver, one of the poorest neighborhoods in Canada (median household income $10,586, poverty rate 73.4 percent). Four Corners operates under the umbrella of the BC Community Financial Services Corporation, a creation of the provincial government and obtained start up funding and deposit guarantees from the government. The National Council of Welfare assessed Four Corners in the 1998 report *Banking and Poor People: Talk is Cheap.* It concluded that opinions on the success of Four Corners were mixed. Some see it as a costly experiment that is not likely to succeed due to its cumulative deficit of $813,000 in 1997, although it had $4.65 million in deposits. The reason for the deficit was attributed to large numbers of small accounts which are not subject to charges. Others suggest that there was not sufficient community participation in the establishment of the bank. On the other hand it has attracted a substantial amount of business from residents and has reduced the number of muggings and thefts of welfare cheques.

In the US the *Community Reinvestment Act* in the US requires banks to meet "the credit needs of its entire community, including low and moderate income neighborhoods, consistent with the sound and safe operation of a bank." The Federal Reserve Board has developed measures for assessing the performance of banks in meeting the needs of low income communities and these data are publicly available. Innovations in the Community Reinvestment Act model have included investment by banks in community venture capital funds. Most analyses of the Act in Canadian public policy documents (Mackay Task Force, White Paper) have been rather limited although it is clear that the idea of equality of access and opportunity, which are important aspects of the US Act, are also relevant in Canada[209]. This is recognized in the White Paper where the proposed Financial Services Authority will be required to monitor the role of Banks in serving the community.

5. Short Term loans for necessities

The Golden Report on homelessness urged the greater development of "rent banks" which provide one time rental assistance to cover a short term arrears problem. The City of Toronto has currently a pilot rent bank. Perhaps an extended model of such a bank could cover other necessities and act as a substitute for payday loans. In the state of Wisconsin the legislature has created a jobs access loan fund. The purpose is to allow eligible applicants to borrow up to US$1,600 at no interest if the loan will help them to find or retain employment and will be used to address an immediate and discrete financial crisis.[210]

6. Counselling and education

This is obviously important and there are a variety of institutions involved in this project. It is difficult to disagree with the importance of education and counselling. However, the introduction of mandatory counselling in the bankruptcy process indicates that there is substantial disagreement as to the nature, objectives and values of counselling.[211] The findings on bounded rationality also suggest limits of the influence of counselling on decision making. However, the increased interest in counselling suggests that some systematic analysis of this field would be useful.

VI: Conclusion

The institutions considered in this paper have both benefits and costs for consumers. The benefits are that they may meet the needs of certain groups of consumers for short-term loans and extend the availability of credit to individuals who might not have received credit from the mainstream financial sector. There are however costs. These include the payment of a high initial price for these services, the danger of subsequent onerous "rollovers " or "refinancings", and the possibility of being subject to onerous collection and repossession practices. Some may be subject to deceptive and fraudulent selling practices . Since consumers who use these services are drawn primarily from lower income groups, the consumer detriment which they suffer may be significant, even if the amounts at stake may not appear large to more affluent consumers. Where the alternative financial sector is being used to purchase the necessities of life this detriment may be conceptualised as similar to a regressive form of taxation. It is ironic that publicly quoted companies engaged in sub-prime lending in the US are very profitable investments so that those who invest in the stock market (generally more affluent individuals) profit from the high prices charged to lower income consumers. The world of the alternative financial sector is no longer solely that of the small operators described by David Caplovitz in *The Poor Pay More* but the public policy challenges remains the same: to attempt to ensure that the needs of vulnerable consumers are met in a less costly manner, to regulate abusive practices effectively, and to ensure that individuals in the alternative financial sector receive a similar level of consumer protection to middle income consumers.

Endnotes

1. See for example Rolf Nugent, "The Loan-Shark Problem" (1941) 8 *Law and Contemporary Problems* 3 where he describes the "tremendous and insistent demand for small loans to wage earners" in early twentieth century US and the subsequent development of the Small Loans Laws. There is also noted the "five-for-six boys" who would advance a wage-earner $5 on a Monday, repayable by $6 dollars come Friday pay-day. This represents an Annual Percentage Rate (APR) of over 1000 per cent. See Jackson Collins "Evasion and Avoidance of Usury Laws" (1941) 8 *Law and Contemporary Problems* 54 at 55 and see generally Symposium, "Combatting the Loan Shark" (1941) 8 *Law and Contemporary Problems* 1-205.

2. See The Special Joint Committee of the Senate and the House of Commons on Consumer Credit and the Cost of Living *Report on Consumer Credit* (1967) (Croll/Basford Report) at 3.

3. Caplovitz argued that the poor should not be merely viewed as exploited workers but also as exploited consumers. He identified several reasons why the poor paid more: the prevalence of deceptive and fraudulent selling and collection practices in low income neighborhoods; the fact that supplier costs in this market were higher than in other markets; transportation costs; and habit and convenience which may deter individuals from shopping outside their neighborhood.

4.See generally National Anti-Poverty Organization "Poverty Statistics at a Glance" (http://www.napo-onap.ca/nf-glanc.htm)

5. Daniel Treffler comments in a recent issue of *Policy Options* that "since peaking in the late 1970s, earnings of males under 25 have declined by 30 per cent" and that "freshly minted high school graduates earned more in 1968 than freshly minted university graduates do now. Further, the dispersion in wages among the young is far greater today than it was in the summer of love. See D. Treffler, "Does Canada need a productivity budget?" (1999) Policy Options July-August at 71.

6. See M. Ornstein "Income and Rent: Equality Seeking Groups and Access to Rental Accommodation Restricted by Income Criteria" (unpublished, on file with author) cited in *In the Matter of Ontario Human Rights Commission and Dawn Kearney* Board of Inquiry decision No 98-021 available at (http://www.web.net/cera/dec22ohrc.htm)

7.Canadian Council on Social Development, *Personal Security Index* (1999) at 11.The "record level" noted by the Bank of Canada is found in "Developments in the balance sheet of the household sector over the past two decades" (1992) *Bank of Canada Review* 3 at 12.

8. I am indebted to Philip Halliday and Statistics Canada for providing the debt-to-income ratios for 1984.

9. See G. B. Canner, A. B. Kennickell and Charles Luckett, "Household Sector Borrowing and the Burden of Debt" (1995) *Federal Reserve Bulletin* 324 at 334.

10. Canadian Council on Social Development *Personal Security Index* , *supra* note 7 at 11. Data provided to the author by the OCA and based on Statistics Canada sources indicates a savings rate of 1.4 per cent in the first quarter of 1999, the lowest saving rate on record.

11. Department of Finance Canada, *Reforming Canada's Financial Services Sector: A Framework for the Future* (1999) at 48.

12. See Task Force on the Future of Canadian Financial Services *Change, Challenge, Opportunity* (September,1998) at 162. The estimate of 3% was based on a telephone survey which would underestimate the number of unbanked.

13. See, Promoting Economic Action and Community Health (PEACH) "The 1999 Research Report on Community Attitudes to Banking in the Jane-Finch Community" (June 1999) by Ruth Morris and Doret Phillips. (Unpublished, on file with author)

14. See *Banking and Poor People: Talk is Cheap* National Council of Welfare at 13 citing to a study by *Options Consommateurs Les Portes Closes (*Montreal, June 17, 1998).

15. See Leonhardt, "Two Tier Marketing" *Business Week* March 17 1997, 82-90 cited in G. Squires "Fringe Banking in Milwaukee" (forthcoming *Urban Affairs review*) at 21. This phenomenon has significant implications for consumer protection theory such as the argument that the marginal consumer protects other consumers through her careful shopping habits. If marginal consumers are being "creamed off" from other consumers then they will not be shopping in the same market as the infra-marginal consumers.

16. See generally James W.St. G. Walker, *"Race", Rights and the law in the Supreme Court of Canada: historical case studies* (The Osgoode Society for Canadian Legal History and Wilfrid Laurier University Press, 1997)

17.See generally G. Stromberg, *Investment Funds in Canada and Consumer Protection: Strategies for the Millennium* A review prepared for Office of Consumer Affairs, Industry Canada (1998).

18. See Canadian Council on Social Development, *Personal Security Index supra* note 7 at 10.

19. See H. Tokunga, "The Use and Abuse of Consumer Credit: Application of psychological theory and research" (1993) *Journal of Economic Psychology* 14 at 285, cited in R. Kerton "Consumers in the Financial Services Sector" Volume 1. Research Paper prepared for the Task Force on the Future of the Canadian Financial Services Sector *supra* note 12.

20. Kerton id. at 11.

21. See S. Schwartz and L. Anderson, *An Empirical Survey of Canadian Bankrupts* (Industry Canada, 1999): I. Ramsay, "Individual Bankruptcy: Preliminary Analysis from a Socio-Legal Study" (1999) 37 *Osgoode Hall L. J.* (forthcoming).

22.See Abdul Rashid, Family Income Inequality 1970-1995, *Perspectives on Labour and Income* Winter 1998 12 Statistics Canada -Catalogue no. 75-001-XPE where he notes that inequality in family income as measured by the Gini coefficient increased from .352 in 1970 to .373 in 1995. This is a significant change. The author notes that without government transfers inequality would be greater.

23. Data provided by OCA/Statistics Canada indicates that after tax incomes of the top 20% of Canadian families fell 4.3% over the 1989-97 period while the bottom 20% of families suffered a decline almost twice as large (8.3%).

24. From 1989 to 1998 consumer credit grew 5.7% a year while mortgage credit increased by 6.7% (Statistics Canada, data provided to author by OCA).

25. R. Pollin, " Deeper in Debt: The Changing Financial Conditions of US Households" (1990) (Washington: Economic Policy Institute).

26. R. Berthoud and E. Kempson, (1992) *Credit and Debt: The PSI Report* (London: Policy Studies Institute) at 64.

27. See "Ontario Government Addresses Consumer Complaints in 1998" (http://www.ccr.gov.on.ca/mccr/240a_272.htm)

28. Information provided by counselling agencies suggest that individuals are often unaware of the powers of collection agencies and their rights in relation to these agencies.

29. A central text in the US is J. Caskey, *Fringe Banking: Check Cashing outlets, pawn shops and the poor* (New York: Russell Sage Foundation, 1994). See also R. Swagler, J. Burton, J.K.Lewis, "The Alternative Financial Sector: An Overview" 7 *Advancing the Consumer Interest*: J. Burton, R. Swagler, J.K.Lewis, "The Alternative Financial Sector: Policy Implications for Poor Households" (1996) *Consumer Interests Annual* 279: J.Lewis, R. Swagler and J.Burton, "Low Income Consumers' Use of the Alternative Financial Sector" (1996) *Consumer Interests Annual* 271. See also M. Hudson, *Merchants of Misery* (1996).

30."Sub-prime lending" refers to those with spotty or blemished credit histories or higher-risk debtors. See e.g. Consumer Reports *Poverty Inc.* July 1998 at 29 (describing the growth of sub-prime lending in mortgages and car loans and the rent-to-own business). In the US, sub prime lending accounted for 15 percent of home-equity loans in 1997 and 14 percent of used-car loans.

31. Our survey indicated that the number of pawnbrokers listed in a business directory for the Toronto area had almost doubled between1996-99 and that a similar pattern existed in Northern Ontario.

32. See, for example *Mackay v. Bank of Nova Scotia* (1994) 20 O.R. (3d) 697.

33. See *supra* note 30.

34. These include the rent-to-own industry and sub-prime automobile lending institutions.

35. Information provided by provincial officials in British Columbia. See also "The Economist" June 5 1999 "Pay Dirt".

36. For example, see the practices outlined by Stromberg in her discussion of the regulation of the sale of mutual funds above at note 17.

37. It is difficult to obtain evidence to substantiate this claim but see discussion below at Part 111,4

38. There is a long history here. Clarence Wassam in his book *The Salary Loan Business in New York City* (1908) outlined the various techniques which salary lenders used to attempt to evade the usury laws.

39. I exclude those such as landlords, grocery stores, tavern owners and so on who may from time to time cash cheques for individuals.

40. This is based on a survey of business directories and Yellow Pages.

41. See the 1998 *Report on Form 10 -K to the US Securities and Exchange Commission* by Dollar Financial Group. Dollar states that it is the second largest cheque cashing store network in the US and in 1996 it took over the leading Canadian provider, National Money Mart.

42. See *Public Opinion Research relating to the Financial Services Sector* by Ekos Research Associates, Research Paper prepared for the Task Force on the Future of the Financial Services Sector, September 1998 at 25.

43. See PEACH (Promoting Economic Action and Community Health), The 1999 Research Report on Community Attitudes to Banking in the Jane-Finch Community by Ruth Morris and Doret Phillips at 3 (on file with author).

44. Dollar Financial Group states that in 1997 its core customer group comprised individuals between the ages of 18-49 who rent their home, are employed and have a median income of $22,500. Based on an internal consumer survey of its Canadian operation, Dollar "believes that the demographics of Money

Mart customers are similar to those of the company's existing US customers. The survey found that approximately 80% of Money Mart's customers have annual incomes below $30,000 and 75% are under the age of 35." See above note 41.

45. Id.

46. Id. and see "Low Income Consumers' Use of the Alternative Financial Sector" (1996) 42 *Consumer Interests Annual* 271.

47. Dollar survey suggested that 65% of users had a bank account.

48.In our survey of cheque cashing companies there did not seem to be differential fees for cashing payroll or government cheques. However a number of cashers would not cash personal cheques or charged a significantly higher fee. Some indicated also that they preferred payroll cheques from large companies and one would only cash government cheques.

49. See "The High Cost of "Banking" at the Corner Check Casher: Check Cashing Outlet Fees and Payday Loans", Jean Ann Fox, Matt Gordon and Leslie Borja, Consumer Federation of America (August 1997). Squires recent study in Milwaukee notes that the charge for a $100 paycheck or government check is between $1.75 - $2.90. See "Fringe Banking in Milwaukee: The rise of check cashing businesses and the emergence of a two-tiered banking system" (1999) *Urban Affairs Review*

50. In the US, companies may use database services such as Tele-Track which claims to be "the central source of information on sub-prime consumers" and which maintains records of uncured defaults as well as providing the current address and employment information on sub-prime consumers.

51. A minimal transaction bank account is described as involving 3 withdrawals, 4 bill payments and 2 cheques. See (http://strategis.ic.gc.ca/SSG/ca01110ehtml)

52. For example New York has a ceiling of 1.4 percent. Caskey found in 1991 that in those states where there was no regulation of cheque cashing services, the charge was between 1.5% and 3% with the most common charge being 2 percent.

53. See Caskey above at p.114.

54. Caskey *supra* Chapter 6.

55. Letter to author by President of Money Mart, September 10, 1999 (on file with author). Licensing authorities in Colorado indicate that the average advance is approximately $125. See Administrator of the Uniform Consumer Credit Code, *1998 Post-Dated Check Cashers Supervised Lenders Annual Report* <www.ago.state.co.us/uccc/annrep/pdannrep.htm>

55."New Lenders with huge fees thrive on workers with debts" *New York Times* June 18, 1999.

57. See "Investors could cash in on growth in fringe banks" *Denver Post* 5/5/96.

58. See "Community West BancShares to Develop Consumer Loan Product Available through ACE Cash Express Stores" (http://biz.yahoo.com/prnews/990817/tx_ace_cas_1.html) Press release, August 17,1999. Another major industry player is Check into Cash, which is now listed on the NASDAQ exchange. It commenced operations with one store in 1993 and grew to 266 stores in June 1998 with current revenues of 21.2 million for the six months ended June 30, 1998. Bad debt expenses as a percentage of revenues were 5.3%.

The company indicates that 93.4% of transactions were closed during the loan period or within four days following this period. Of these transactions, 11.5 percent were extended (rollovers) .

59. See Equity Analytics summary of Check into Cash IPO (underwritten by CIBC Oppenheimer) (http://www.e-analytics.com/ipo/1998/july/chek.htm)

60. See Consumer Federation of America, "Bounced Checks: Billion Dollar Profitsll " (1997) at 5.

61. As reported in "The Economist" supra. The National Check Cashers Association claims that the "average user has a personal, or family income in the range of from $20,000 to $25,000 on the low side to $35000 to $45000 on the high side. The clientele is nowhere near the poverty line, but rather part of the self-sustaining American middle class." They quote an industry study which indicates that the average length of residence is almost 4.4 years, the average tenure in current employment is almost 4 years and 35.8 percent are homeowners. National Association of Check Cashers "Freedom of Choice for Consumers: The Truth about Deferred Deposit Services -A reasoned response to the CFA's misrepresentation" <www.nacca.org/ddresponse.htm>

62. Letter to author above note 54. It is not clear whether the individuals surveyed self-identified within these categories or were classified by the researchers within a recognised occupational scale such as the Pineo-Porter-McRoberts scale of occupations.

63. In a survey conducted by its marketing department, Money Mart found that the most common reason was "no real reason, just wanted some extra cash for a few days" (42%), while 29% indicated paying off overdue bills and 17% an unexpected emergency. Id.

64.See *New York Times supra.* note 55.

65. See above footnote 63. One government official indicated to the author that they might be used by individuals with unexpected dental expenses in a situation where a person has lost their job and is no longer covered by an occupational plan. Another suggested that collection agencies tell debtors to obtain a payday loan to pay off a debt and that a small minority of loans might be used for gambling or addictions.

66. 1998 Post- Dated Check Cashers Supervised Lenders Annual Report 1998 <www.ago.state.co.us/uccc/annrep/pdannrep.htm>

67. Section 347 includes a wide variety of charges under interest (aggregate of all charges and expenses whether in the form of a fee, fine, penalty, commission or other similar charge or expense...) and the broad interpretation given to the section by the Supreme Court of Canada in *Garland v. Consumers Gas* [1998] 3 SCR 112 would bring payday loans within the scope of the section.

68.[1998] 3 SCR 112.

69. For a useful discussion of the different methods of calculating interest see E. Maynes, S. Pincus and C. Robinson, "Calculating Periodic Interest" (1991) 17 *Canadian Bar Journal* 415.

70. See R. M. Goode, *Consumer Credit Law* at 317.

71. See National Check Cashers, *Freedom of Choice for Consumers: The Truth about deferred deposit services–A Reasoned Response to the CFA's misrepresentations* <www.nacca.org/ddresponse.htm>

72. In our survey in Toronto few providers indicated that they would "rollover" a loan. Data from the US indicates that in 1998 in Colorado 21% of payday loans were refinancings. See Administrator of the Uniform Consumer Credit Code, *1998 Post-Dated Check Cashers Supervised Lenders Annual Report*

<www.ago.state.co.us/uccc/annrep/pdannrep.htm>

73. One industry analyst is quoted as stating that the average customers of payday loan companies makes 11 transactions a year, suggesting that they are not being used solely for emergencies. John Evanson quoted in Mark Anderson "Cash poor, choice rich: Paycheck Advance Firms Move in" *Sacramento Business Journal* January 11, 1999. <www.amcity.com/sacramento/stories/1999/01/11/story3.html>

74. Based on information reported by debt counsellors in British Columbia and provided to author by provincial officials. We did not obtain systematic data on this issue but Money Mart indicates that they charge $25 for cheques returned NSF. As indicated in the text, one company quoted an NSF charge of $100.

74. Regulators in Ontario and British Columbia did not have evidence of this occurring in their respective provinces but it does occur in the US. A class action lawsuit has been launched against Nationwide Budget Finance, a payday loan company for sending consumers in Illinois letters such as the following:

POLICE WARRANT INTENDED

THIS LETTER WILL SERVE AS A FINAL NOTICE...WE HAVE CONTACTED THE CITY OF CHICAGO POLICE DEPARTMENT. THEY ARE AWARE OF YOUR BAD CHECK WITH NATIONWIDE BUDGET FINANCE

IT IS A FELONY TO WRITE A BAD CHECK IN THE STATE OF ILLINOIS YOUR FAILURE TO RESPOND TO THIS NOTICE WITHIN 72 HOURS WILL RESULT IN US APPLYING FOR A WARRANT FOR YOUR ARREST.

See PR Newswire September 1, 1999, provided to author by Philip Halliday OCA.

76. See National Consumer Law Centre "Payday Loans: A Form of Loan Sharking. The Problem. Legislative Strategies, A Model Act" (on file with author).

77. See "Honey, I pawned the Jacuzzi" *Canadian Business* November 1996 at 72-75 (describing the surge in pawnbrokers in Alberta). See also the interesting article by Edward Veitch, "The Law O' the Brass Balls OR the regulation of the pawn" (1992) 21 *Canadian Business Law Journal* 49.

78. See Edmonton Journal, August 19, 1999 discussing the expansion of "Cash Canada" which has eight stores. In the US there are four publicly traded pawnshop chains with almost 700 stores and the industry may be in the process of consolidation.

79. See Caskey *supra* note 29 and information provided by Toronto police.

80.See National Association of Pawnbrokers (http://npa.polygon.net/infopawn.html)

81. Veitch *supra* at 50. Caskey, based on interviews with pawnbrokers concluded that "the vast majority of their customers have low or moderate incomes, with a high school education or less...probably younger than average for the adult population. A disproportionate percentage of customers is African American or Hispanic....pawnbrokers believe that most of their customers rent their homes and that many move frequently, have bad credit records, and do not maintain bank accounts. They believe that a large share of their customers generally live from paycheck to paycheck and do a poor job of managing their personal finances". Caskey, *supra* at 69.

There is an interesting empirical study of pawnbroker use in Victoria, Australia, by the Financial and Consumer Rights Council. See (http://home.vicnet.net.au/~fcrc/research/pawn/pawn_f.htm)

82. Veitch refers to the unreported Manitoba case of *R. v Dimerman* where the effective interest rate on a $350 loan was between 937% and 1375% and see also *R v. Duzan* (1992) 99 Sask. R. 171 where the interest rate was 470% and 590%. A recent police crackdown on unlicensed pawnshops in the Toronto region found shops

charging as much as 800%. See "Pawn Shops hit with Charges in crackdown" *Toronto Star* June 4, 1999.

83. Gordon Reydkal, reported in "Profit: The Magazine for Canadian entrepreneurs" June 1998.

84. Michael Hudson, *Merchants of Misery* (1996) at 147 where he refers to Continental Rentals owner Michael Schecter who stated in a court deposition that "most of our customers are throwbacks from the retailers that will not deal with them...they have limited incomes and they simply can't save money."

85. J. Caskey *Fringe Banking* (1994) at 80 citing to R. M. Swagler and P. Wheeler "Rental Purchase Agreements: A Preliminary Investigation of Consumer Attitudes and Behaviors" (1989) *The Journal of Consumer Affairs* 145-160.

86. See S.L. Martin and N.W. Huckins, "Consumer Advocates v. The Rent to Own Industry: reaching a reasonable accommodation" (1997) *American Business Law Journal* 385

87. See Consumer Reports *supra* and see generally on rent-to-own in Canada M. Guénette, "L'Entreprise Louer pour Acheter, là où on vend de deux ou trois fois plus cher qu'ailleurs" Option Consommateur hiver 1997.A competitor to rent to own may also be the offers of buy now pay later (no payments till..) which often carry interest rates of around 30 percent if the payments are not made on the due date. I have been informed that consumers who use these plans often do not pay by the due date and incur significant interest charges.

88. It has been argued that the transaction is not a loan but a purchase of the refund or a payment for services. However tax rebate discounting would, under the *Garland* decision probably fall within section 347 which is perhaps why the Federal legislature excluded tax rebate discounting from its scope.

89. Data provided by Revenue Canada, Tax Filer Services Section August 11, 1999 (unpublished, on file with author). " Single" denotes divorced, widowed or single. A 1985 government report noted that "2 out of 3 persons who discounted reported a 1983 income of less than $8000 and nearly 1 out of 3 reported an income of less than $2000. It can therefore be concluded that low-income Canadians form the bulk of the clientele of discounters".

90. I draw on the history as recounted in M. Milcynski "Tax Rebate Discounting in Canada: The Case for Abolition" (1987) 2 *Journal of Law and Social Policy* 73 and also L.Sossin, " Squeezing Blood from Stones" (1992)8 *Journal of Law and Social Policy* 191.

91. See *Hanson, Director of Trade Practices v. John's Tax Services*, unreported, March 5, 1975 (BCSC) cited in E. Belobaba, "Regulating the Income Tax Discounter; a study in Arbitrary Government (1979) *Canadian Taxation* 21 at note11.

92.See *Re Hanson* (1978) 87 DLR (3d) 96 BCCA .

93. Under the current statute the discounter is entitled to 85% of the first $300 and 5% of the balance. Nova Scotia and Manitoba require that tax discounters register provincially.

94. See R. Hasson, "Canada's Road to Usury" in I. Ramsay (ed.) *Consumer Law in the Global Economy* (1997) at 303. Hasson notes that research on welfare fraud indicates that a prison sentence was imposed in 40 out of 50 cases.

95. S.O. 1994 c.22.

96. Much of the data in this section are extracted from the submission of the Association of Canadian Financial Corporations to the Task Force on the Future of the Canadian Financial Services Sector (November 6, 1997). The Association comprises Associates, Avco, Beneficial, Household, Superior, and Trans Canada Credit. Avco has now been taken over by Associates. The figure of 1.74 million may contain some commercial customers as well as consumers.

97. Submission to the Task Force on the Future of the Canadian Financial Services Sector in response to its discussion paper, June 1997 by the Association of Canadian Financial Corporations, November 6 1997 at pp2-3.

98. See "Bottom Feeders: they go where big banks fear to lend and charge plenty for it". *Financial Post* November 9, 1996 at 18.

99. Both Avco and Household Financial report returns on equity of 15% in 1998 as do the Bank of Nova Scotia and the Bank of Montreal. See "Top 100 Financial Institutions" *Financial Post* 500 at 174 (1999).

100. Avco Report of Form 10K to the US Securities and Exchange Commission (1997).

101.Id.

102. See the overview in G. Marsh, "The Hard Sell in Consumer Credit: How the Folks in Marketing can put you in court" (1998) *Consumer Finance Quarterly Report* 295 and see opinion of Posner J. in *Emery v. American General Finance Incorporated* (1995) 71 F. 3d. 1343

103. See Consumer Reports, *Poverty Inc. supra.*

104. For a full description of these practices and the responses by the FTC see "Home Equity Abuses in the Subprime Mortgage Industry" Prepared statement of the Federal Trade Commission by Jodie Bernstein, Director, Bureau of Consumer Protection before the Senate Special Committee on Aging, March 16,1998 (http://www.ftc.gov/os/1998/9803/grass5.htm)

105. See "Credit Cards and the Poor" E.J. Bird, P.A. Hagstrom, and R.Wild IRP Discussion Paper 1148-97 University of Wisconsin Madison, 1997. "Poor" refers to families with incomes below the Federal poverty line for families of that size.

106. See *Vulnerable Consumers and Financial Services, The Report of the Director General's Inquiry* (1999) at 3 "It is often claimed that those who fail to take up even the most basic of financial services have done so out of choice. My scepticism of such claims has been confirmed by the analysis and research in this report. The take up of bank current accounts, household insurance and short term credit is inconsistent with the exercise of any meaningful choice".

107. J. Murray Smith, "Street Youth and Banking: A Needs Assessment for Banking Services for Youth (December 1996) (prepared for the Pape Adolescent resource Centre and the Healthy City Office, City of Toronto).

108. See eg *Yale Law Journal* (1967) "Consumer Legislation and the Poor" 745 at 753 where it is stated that " a low income consumer is profoundly different from a middle class consumer...Underlying his problems and essential to any discussion ..is a crucial lack of motivation. [The poor] are "shy and unwilling to deal with strangers". A study of bankruptcy concluded that the plight of the majority was partly attibutable to "other deficiencies in life skills and resources which are associated with, but not limited to, the lower social classes. See W.Brighton and J. Connidis, *Consumer Bankrupts in Canada* (Ottawa: Consumer and Corporate Affairs Canada,1982) at 77. Johnson, in his history of working class credit charts the continuance of what he describe as a middle class failure to understand the problem of "mean streets" from the perspective of "mean streets" and cites to reformers who commented for example that "The great hindrances to saving are laziness and self-indulgence, slavery to impulse, mental apathy, narrowness of outlook.." P. Johnson *Saving and Spending : The Working Class*

Economy in Britain 1870-1939 (1985) at p.218 citing to Margaret Loane, *The Common Growth* (1911) at 105. A study in the late 1970s did not find market irrationality among lower income consumers. See K.McNeil, J.R.Nevin, D. M. Trubek and R.E.Miller, "Market Discrimination against the Poor and the Impact of Consumer Disclosure Laws: The Used Car Industry". (1979) *Law and Society Review* 695.

109. See J. D. Hulchanski and J.H. Michalski "How Households obtain resources to meet their needs; the shifting mix of cash and non-cash sources (Toronto, Ontario Human Rights Commission, 1997).

110. One of the volunteer organizations in Toronto informed us that the majority of their clients who were on welfare used cheque cashing companies but that they do not use payday loans.

111. *Supra.* "Bottom Feeders" (Quoting Murray Wallace, president of Avco Finance).

112. See Hudson *supra* at 152.

113. This has long been an observation of studies of low income markets. See e.g. Caplovitz, Greenberg, "Easy Times: Hard Times: Complaint Handling in the Ghetto" in L. Nader (ed.) *No Access to Law: Alternatives to the American Judicial System* (Academic Press:1980). See also in the UK I. Crow, G. Howells, and M. Moroney, "Credit and Debt: Choices for Poorer Consumers" in Howells. Crow and Moroney (eds) *Aspects of Credit and Debt* (1993) Chapter 2 and J. Ford and K. Rowlingson, "Low Income households and credit:exclusion, preference, and inclusion" (1996) 28 *Environment and Planning* 1345.

114. See I. Ramsay, *Consumer Protection* (1989) Chapter 2; I. Ramsay, *Rationales for Intervention in the Consumer Marketplace* (Office of Fair Trading, 1984).

115. This report published in 1967 is often referred to as the Croll/ Basford report. The Report made a number of recommendations in relation to low income consumers. They noted at the outset that "It would greatly aid the fight against poverty if needy people were given access to credit on reasonable terms". (p.4).

116. A useful statement of the traditional approach is D. Cayne and M. J. Trebilcock, "Market Considerations in the Formulation of Consumer Protection Policy" (1973) 23 *University of Toronto Law Journal* 396

117. This was one of the reasons put forward by Caplovitz in *The Poor Pay More* for higher prices in low income neigborhoods. Anecdotal information provided to me suggests that this certainly is an issue in certain parts of Toronto and presumably other Canadian cities.

118. See Office of Fair Trading, *supra* at 10.

119. See D. Cayne and M. Trebilcock, "Market Considerations in the Formulation of Consumer Protection Policy" (1973) 23 *University of Toronto L.J.* 396.

120. R. M. Goode, (ed.) *Consumer Credit* (Boston: A.W. Sijthoff, 1978) at 98.

121. See e.g. Federal Select Committee, Consumer and Corporate Affairs "A study of credit card and charge cards in Canada" (1992) submission by Michael Fraser of the Fraser Institute " a single mother with a low income will be most likely to lose her credit card if caps are introduced; without access to credit, of course, the single mother would face an intolerable burden if her income and savings were not enough to buy snowsuits for her children. Others with low incomes, minorities, young adults, immigrants and those with below-average levels of education are also most likely to lose their credit cards".

122. See the exchange between R. Hasson and E. Belobaba in Canadian Taxation. See E. Belobaba, "Regulating the Income Tax Discounter: A study in arbitrary government" (1979) 1 *Canadian Taxation* at 21 and Hasson, "In Defence of Simple Solutions for Simple Problems -A Reply" (1979) 1 *Canadian Taxation* 25.

123. See discussion of the impact of protective provincial legislation in the area of mortgages in "Mortgage Remedies in Alberta" Alberta Law Reform Institute ,1994 and see Schill "An Economic Analysis of Mortgagor Protection Laws" (1991) 77 *Virginia Law Review* 485..."home mortgage loans are relatively insensitive to the existence of mortgagor protection laws".. In relation to credit cards note the comments of A. Finlayson and S. Martin in relation to the equation of low income with high risk "the banks own figures suggested that people on low incomes were more likely to avoid interest charges by paying off their card balances each month". A. Finlayson and S. Martin *Card Tricks* (1993) at 279. In relation to creditors remedies see Grau and Whitford, "The Impact of Judicializing Repossession: The Wisconsin Consumer Act Revisited" (1978) *Wisconsin L .rev.* 983.

124. I outline some of these in I. Ramsay *Rationales for Intervention in the Consumer Marketplace* (Office of Fair Trading, 1984).

125. See s75 Consumer Credit Act

126. See J. Legrand, "Knights, Knaves or Pawns? Human Behaviour and Social Policy" (1996) *Journal of Social Policy* 149.

127. The most comprehensive analyses of this phenomenon in the legal literature are J.H. Hanson and D. Kysar, "Taking Behaviouralism Seriously: The Problem of Market Manipulation" (1999) 74 *New York University Law Review* 630 and C. Jolls, C.Sunstein and R. Thaler, " A Behavioural Approach to Law and Economics" (1998) 50 *Stanford L. rev.* 1471.

128. See T. O' Donoghue and M. Rabin, "Doing it Now or Later" (1999) *American Economic Review* 103. See also G. Loewenstein and J. Elster *Choice over Time* (1992).

129. See G. Loewenstein and R. Thaler, "Intertemporal Choice" in R. Thaler *The Winners Curse* (1992) Chapter 8.

130. Id. at 99.

131. Caskey *supra* at 81.

132. O' Donohue and Rabin *supra* at 103.

133. This is described as the "availability" heuristic which originated with a paper by Tversky and Kahneman titled "Availability: A Heuristic for Judging Frequency and Probability" (1973) 5 *Cognitive Psychology* 207.

134. Hanson and Kysar *supra* citing to N. Weinstein and W. Klein "Resistance of Personal Risk Perceptions to Debiasing Interventions" (1995) 14 *Health Psychology* 132 at 132.

135. J. Conlisk, "Why Bounded Rationality?" (1996) *Journal of Economic Literature* 669 at 684.

136. J. Hanson and D. Kysar, "Taking Behaviouralism Seriously: Some Evidence of Market Manipulation" (1999) 112 *Harvard Law Review* 1420.

137. See A. Tversky and D. Kahneman "The Framing of Decisions and the Psychology of Choice" 211 *Science* 453 (1981)

138.See R. Thaler (1980) "Towards a Positive theory of consumer choice" 1 *Journal of Economic Behaviour and Organization* 39. For a response by neo-classical scholar E. Kitch, "The framing hypothesis: is it supported by credit card issuer opposition to a surcharge on a cash price? 6 *Journal of Law, Economics and Organization* 217.

139. See Robert Frank, "The Demand for Unobservable and Other non positional goods" (1985) *American Economic Review* 101.

140. D. Kahneman, J.Knetsch and R. Thaler, "Fairness as a Constraint on Profit Seeking: Entitlements in the Market" 76 (4) (1986a) *American Economic Review* 728.

141.See discussion by Vaughan in R. Vaughan, "Distributional Issues in welfare assessment and consumer affairs policy" (Office of Fair Trading, 1999) Chapter 4. The concern about the regressive impact of high credit prices for lower income consumers is similar to concerns about the impact of indirect taxes such as GST on lower income consumers.

142. See L.Lessig, "The New Chicago School" (1998) 27 *Journal of Legal Studies* 661.

143. See K. Duffy, *Social Exclusion and Human Dignity in Europe* Council Of Europe (1995).

144. See *Banking on Consumer Power: The Issues for a Canadian Consumer Coalition for the Banking Industry* written by Angie Barrados (Public Interest Advocacy Centre and Consumers' Association of Canada).

145. Department of Finance Canada, *Reforming Canada's Financial Services Sector: A Framework for the Future* June 25, 1999 at 47- 48.

146. See A. Giddens *Beyond Left and Right* (1994).

147. I discuss these theories in I. Ramsay *ConsumerProtection* (1989) at pp.13-24.

148. Caskey *supra* at 9. Caskey's comments were directed to the regulation of pawnshops and cheque cashing organizations.

149. I discuss these issues further in I.Ramsay *Consumer Protection* (Weidenfeld and Nicolson, Law In Context, 1989) at Chapter 6.

150. See M. Waldron, *The Law of Interest in Canada* (Carswell: 1992) at 28 See e.g. *Attorney General for Ontario v. Barfried Enterprises* [1963] SCR 570 (provincial unconscionable transactions legislation in substance concerns regulation of contract not interest: also narrow definition of interest suggested as limited to charges which "accrue from day-to-day): *Tomell Investments Ltd. v. East Marstock Lands Ltd.* (1977) 77 DLR (3d) 145 (SCC) (broad definition of interest in s.8 of Federal Interest Act upheld as ancillary to control of interest and to avoid thwarting the effective use of the Interest power.) See also *Re Hanson* (1978) 87 DLR (3d) 96 (BCCA) (narrow definition of interest used to uphold provincial regulation of Tax Rebate Discounting which limited the maximum discount to 15 per cent). Mary Anne Waldron notes also that for many years provinces controlled the interest rates at which credit unions might lend. Although this power was never challenged constitutionally, she argues that exercise of this power could have been upheld under the provincial power to regulate creatures of its own legislation..

For US analysis see *Smiley v. Citibank* 116 S.Ct. 1730 (1996) (taking a broad approach to include late penalties and charges within definition of interest). This case benefited the interests of credit card companies. It is an ironic decision since creditors had long argued that courts should take a narrow view of interest under state usury statutes. One writer comments that after the *Smiley* decision "for some purposes the word "interest" includes charges like late fees, but for other purposes it does not. The net result for consumers is a defeat on both counts". James Nehf, "Trends in Enforcement of Consumer Rights in the US and Canada" in S. Sothi Rachagan *Consumer Protection in the WTO Era* (IACL;1999 Louvain la Neuve) at 86.

151. For a useful overview of the problems here and in particular the failure of the Federal *Borrowers and Depositors Protection Act* see N. Sidor, *Consumer Policy in the Canadian Federal State* (1984).Chapter 4 and Burns *The Borrowers and Depositors Protection Act: A Case History in Legislative Failure* (MBA Thesis: UBC,1981).

152. See White Paper *supra* at 55.

153. Id. at 66.

154. See e.g. W. Whitford, "Structuring Consumer Protection Legislation to Maximise Effectiveness" (19 81) *Wisconsin L. Rev.* 1018 at 1019-1021.

155. See for example *Motor Vehicle Manufacturers Ass'n v. Wrye* (1988) 64 OR (2d.) 212.

156. See judgment of Major J. in *Garland v. Consumers Gas Co,* [1998] 3 SCR 112.

157. See e.g. this technique in relation to automobile repairs in Ontario. Section 11 *Motor Vehicle Repair Act* R.S.O. 1990 c M-43 which prohibits any charge in contravention of the Act being recoverable from the consumer.

158.See Lambert J. in *Harry v. Kreutziger* (1978) 95 DLR (3d) 231 (BCCA).

159. In some cases the courts have been willing to find unconscionability based on excessive cost alone. See *Krocker v. MidTown Mortgage* (1975) 52 DLR (3d) 286 (Alta.) The provincial statutes generally known as "Unconscionable Transactions Relief" are listed in Waldron at 73. There are some provincial variations with British Columbia legislation restricted to mortgage loans for non-commercial purposes.

160. In a case in Ontario heard by the administrative tribunal, it was willing to hold that prices 28% or more above the market norm were "grossly excessive". See *In Big Daddy TV.*

161. An example of the exception is *Rushak v. Henneken* (1991) 6 WWR 569 (BCCA). In *Memorial Gardens Ontario Ltd. v Ontario* [1991] 2 OR (3d) (Ont. CA) the Ontario court of Appeal interpreted unconscionability under the Business Practices Act in the same manner as the common law doctrine. The role of unfair trade practices statutes as a source of norm development is discussed in Stewart Macaulay, "Bambi meets Godzilla: Reflections on Contracts Scholarship and Teaching v. Unfair and Deceptive Practices and Consumer Protection" (1989) *Houston L. Rev.* 575 (noting individualistic and altruistic strands in contracts scholarship and the possibility of trade practices legislation as a source for the development of the latter strand).

162. Macaulay *supra* who notes that many of the automobiles in the US cases are expensive models. In Canada *Rushak* concerned a Mercedes but I have not done a systematic analysis of the case law to test this hypothesis.

163. For a useful Canadian summary of the goals of disclosure legislation see *Issue Paper on Cost of Credit Disclosure prepared for the Uniform Law Conference of Canada* by Richard Bowes (1991) *Uniform Law Conference of Canada Proceedings of the Seventy Third Annual Meeting* 124 at 144-148.

164. On the contract synopsis function see Landers and Rohner (1979) "Functional Analysis of Truth in Lending" 26 *UCLA L.Rev.* 711.

165. See *Consumers Appreciation of Annual Percentage Rates* Office of Fair Trading, June 1994. The Office of Fair Trading concluded in its review of consumer credit that "those surveyed would generally draw the right conclusions from using APRs, even though they might not fully appreciate precisely what the APR represented". *Consumer Credit Deregulation* (1994) at 70

166. This was pointed out in one of the most comprehensive early analyses of truth in lending. See W. Whitford, "The Functions of Disclosure Legislation in Consumer Transactions" (1973) *Wisconsin L. rev.* 400 at 423.

167. *Supra.* Whitford, "Structuring Consumer protection..." at 75.

168. See Howells, "Seeking Social Justice for Poor Consumers" in Ramsay (ed) *"Consumer Protection in the Global Economy" supra* at chapter 14.

169. Extracted from S. L Martin and N. W. Huckins, "Consumer Advocates v. the Rent to Own Industry: Reaching a Reasonable Accommodation" (1997) 34 *American Business Law Journal* 385.

170. A. Schwartz and L. Wilde, "Intervening in Markets on the basis of Imperfect Information" (1979) 127 *University of Pennsylvania Law Review* 630: A. Schwartz, (1995) "Legal Implications of Imperfect Information in Consumer Markets" 151 (1) *Journal of Institutional and Theoretical Economics* 31.

171. See Whitford "The Functions of Disclosure" *supra* at 466-7.

172. Caskey *supra* at 118.

173. See G. Hadfield, R. Howse and M. Trebilcock, "Information-Based Principles for Rethinking Consumer Protection Policy" (1998) 21 *Journal of Consumer Policy*131 at 147.

174. See e.g. M. Schill, "An Economic Analysis of mortgagor protection laws" (1991) 77 *Virginia L. Rev.* 489, Whitford and Grau *supra*.

175. For example, in several US states, many European countries (excluding the UK) , and Israel.

176. See E. Glaeser and J. Scheinkman, "Neither A Borrower nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws" (1994) National Bureau of Economic Research: Working Paper No. 4954.

177. It is well known that the criminal interest rate was passed at the request of the Montreal police who wished to use it to control loan sharking. See J. Ziegel, "Bill C-44: Repeal of the Small Loans Act and the Enactment of a New Usury Law" (1981) 59 *Can. Bar Rev.*188.

178. Permission of the provincial Attorney General is required for a prosecution under s347.

179. This is the argument of Cayne and Trebilcock *supra* "Market Considerations".

180.Caskey, *supra*.

181. The Federal *Tax Rebate Discounting Act* might be regarded as in substance a form of interest rate regulation, permitting a higher rate than would be possible under criminal usury provisions of s347. Tax Rebate discounting is excluded from the scope of section 347.

182. See G. J. Wallace, "The Uses of Usury: Low Rate Ceilings Reexamined" (1976) 56 *Boston U.L.Rev.* 451.

183. See E. Posner, "Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on Freedom of Contract" (1995) 24 *Journal of Legal Studies* 283.

184.Glaeser and Scheinkam reject rent-seeking explanations that interest rate ceilings exist because they benefit more powerful borrowers.

185. See e.g in Ontario *The Safety and Consumer Statutes Administration Act* 1996 S.O. 1996. C.19.

186. See e.g. British Columbia *Consumer Protection Act* RSBC 1996 c.69 Part 2.

187. Licensing of motor vehicle dealers is required in all provinces.

188. Moneylenders, defined as "a person who carries on the business of extending credit" are required to register with the relevant Ministry in New Brunswick, Newfoundland, Nova Scotia and Quebec. See New Brunswick *Cost of Credit Disclosure Act* RSNB 1973 c.C28 ss.1-13, 25-29; Newfoundland, *Consumer Protection Act* RSN 1990 c. C31 ss1-15,24-31; Nova Scotia *Consumer Protection Act* RSNS 1989 c.92 ss 1-16,29-33; Quebec *Consumer Protection Act* RSQ c. P-40.1 ss 321-349.

189. All provinces except Alberta and New Brunswick have legislation requiring licensing of credit reporting agencies.

190. See Nova Scotia, Consumer Protection Regulations N.S. Reg. 206/91 ss1-7, 20-27 under the *Consumer Protection Act* which require licensing of loan brokers.

191. In all provinces collection agents are required to be licensed or else face statutory penalties. In most jurisdictions they must be renewed on an annual basis.

192. The term constructive discrimination is used in the Ontario Human Rights Act. See s11. The origin of adverse impact discrimination is in US employment discrimination cases. See *Griggs v. Duke Power Co.* 401 US 424 (1971).

193. See Kearney *supra* note 6.

194. See Matheson, "The Equal Credit Opportunity Act: A Functional Failure" 21 *Harvard Journal on Legislation* 371.

195.Office of Fair Trading *Vulnerable Consumers supra* at 50.

196. For a useful article on the impact of bank culture on discrimination in lending see P. Swires, "The Persistent Problem of Lending Discrimination: A law and economics analysis" (1994-95) 73 *Texas L. J.* 787.

197. White Paper *supra* at 49.

198. See Street Youth survey *supra* at 16 : "Some complained about the banks attitude towards low-income people..." 'Bank workers are mean and unfair and very greedy. It's like, if you don't have a lot of money they're not interested.' 'They seem unfair to the average working man'.

199. See Canadian Community Reinvestment Coalition, *Access Denied: The Failure of Voluntary Measures to Improve Banking Services* (1999) at pp.19-33.

200. E. Rubin, "The Lifeline Banking Controversy: Putting Deregulation to Work for the Low Income Consumer" (1992) 67 *Indiana Law Journal* 213.

201.Canadian cooperative Association, Financial Co-ops (Credit Unions) (http://www.coopcca.com/canada/financial.htm) (accessed August 14, 1999)

202.See "A Brief Overview" (http://www.desjardins.com/ang/le_mouvt/unbref/bref.htm) (accessed August 14, 1999).

203. It also has the largest credit union outside Quebec, Van City credit union which has assets of $6 billion.

204. For example the Savings and Credit Union of British Columbia in its web page has comments such as "Penguins will fly before big banks will change" (http://www.credit-union.com/economics/index.html) (Accessed August 14,1999)

205. See Options Consommateurs *supra*. However, one public interest group claims that 'caisses populaires discriminate against low income people, unlike...bygone caisses populaires." Quebec Public Interest Research Group *Local and International Experience with Community Barter. Lending and Banking* (October 1997).

206.For a full analysis of this issue see M. Grant "Canada's Social Payment Disbursement System and the financial Services Sector: Moving to a Mandatory Direct Deposit Scheme: The Case of Alberta" Research Paper prepared for the Task Force on the Future of the Canadian Financial Services Sector.

207. It should be noted that there have been concerns expressed about the garnishment of government cheques which are deposited to individuals' accounts.

208. The Canadian Community Reinvestment Coalition lists over 100 groups as members and supporters although not all of these groups are directly involved in community issues concerning bank access.

209. There is a large US literature on the Community Reinvestment Act. For a sampling see A. Taibi "Banking, Finance and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights and Substantive Racial Justice (1994) 107 *Harv. L. rev.* 1463: J. Macey and G. Miller, "The Community Reinvestment Act: An Economic Analysis" (1993) 79 *Virginia L. rev.* 291.

210.See 95-96 Wis. Stats. 49.147 as reported in National Consumer Law Center, Special Issue: Check Cashers, PayDay Loans and Pawns, Consumer Credit and Usury Edition, January/February 1998.

211. See for example the papers in the special forthcoming issue of the Osgoode Hall Law Journal from the conference on Consumer Bankruptcy held in Toronto August 1998.

Appendix 1

MODEL DEFERRED DEPOSIT LOAN ACT

Section 1A. TITLE; PURPOSE

This Act shall be known as the Deferred Deposit Loan Act. This Act shall be liberally construed to effectuate its purpose. The purpose of the Act is to protect consumers who enter into short-term, high rate loans from abuses that occur in the credit marketplace when such lenders are unregulated. This Act is to be construed as a consumer protection statute for all purposes.

Section 1. DEFINITIONS

(a) **Deferred deposit loan** includes any arrangement in which a person accepts a check dated on the date it was written and agrees to hold it for a period of days prior to deposit or presentment, or accepts a check dated subsequent to the date it was written, and agrees to hold the check for deposit until the date written on the check.

(b) **Licensee** means any person licensed by the Commissioner of __ under the provisions of this Act to engage in deferred deposit loans or any facilitator as defined in Section 2(b). For purposes of all sections of this Act with the exception of Section 4, a licensee includes any bank, savings and loan association, credit union, or other state or federally regulated financial institution.

(c) **Commissioner** shall mean the Commissioner of __.

(d) **Person** shall include any natural person, firm, partnership, association or corporation, or other entity who makes a deferred deposit loan in this state or any facilitator as defined in Section 2(b).

(e) **Consumer** shall mean any natural person who, singly or jointly with another consumer, enters into a deferred deposit loan.

(f) **Check** as used in this Act shall mean a negotiable instrument as defined in Article 3 of the Uniform Commercial Code which is drawn on a bank and is to be payable on demand at maturity of the deferred deposit loan.

Section 2. APPLICABILITY

(a) **In General.** Except as otherwise provided in this section, this Act applies to any person who, for a fee, service charge or other consideration, accepts a check dated on the date it was written and agrees to hold it for a period of days prior to deposit or presentment, or

accepts a check dated subsequent to the date it was written, and agrees to hold the check for deposit until the date written on the check.

(b) **Facilitators.** This Act applies to any person who facilitates, enables, or acts as a conduit for another person, who is or may be exempt from licensing, who makes deferred deposit loans.

(c) **Financial Institutions.** To the extent that banks, savings and loan associations, credit unions, or other state or federally regulated financial institution are exempt by virtue of other state or federal laws from the provisions of this Act regarding limitations on interest rates and fees, all other provisions except the requirements for licensure in Section 4 apply to these financial institutions.

(d) **Evasion of Applicability.** The provisions of this Act shall apply to any person who seeks to evade its applicability by any device, subterfuge, or pretense whatsoever.

Section 3. EXEMPTIONS

(a) **Retail Sellers.** Retail sellers who cash checks incidental to or independent of a sale and who charge no more than $2 per check for the service are exempt from the provisions of this Act.

(b) **Financial Institutions.** To the extent that banks, savings and loan associations, credit unions, or other state or federally regulated financial institutions are exempt by virtue of other state or federal laws from the provisions of this Act regarding limitations on interest and rates, all other sections of this Act apply except Section 4.

Section 4. LICENSING

(a) **Necessity for License; Prerequisites to Issuance.** --No person shall engage in or offer to engage in the business regulated by this Act unless and until a license has been issued by the Commissioner. The Commissioner shall not issue or renew any such license unless and until the following findings are made:

(1) That authorizing the applicant to engage in such business will promote the convenience and advantage of the community in which the applicant proposes to engage in business; and

(2) That the financial responsibility, experience, character and general fitness of the applicant are such as to command the confidence of the public and to warrant the belief that the business will be operated lawfully and fairly, and within the provisions and purposes of this Act;

(3) That neither the applicant, nor any principals of the applicant (which includes any persons owning at least 5% of the applicant) have been convicted of any crimes;

(4) That the applicant has unencumbered assets of at least $25,000 per location.

(5) That the applicant has provided a sworn statement that the applicant has not used in the past, nor will in the future directly or indirectly use the criminal process to

collect the payment of deferred deposit loans or any civil process to collect the payment of deferred payment loans not generally available to creditors to collect on loans in default.

(6) Such other information as the Commissioner may deem necessary.

(b) **Annual Review of Compliance with Law**. No license shall be issued for longer than 1 year and no renewal of a license shall be provided if licensee has violated this Act.

(c) **Public Hearing**. A public hearing shall be held for each original application and for renewals if one is requested in writing by five or more members of the public or the Commissioner.

(d) **Bond**. Each licensee must post a bond in the amount $50,000 per location which must continue in effect for 5 years after the licensee ceases operation in the state. Such bond must be available to pay damages and penalties to consumers harmed by any violation of this Act.

(e) **Fees**. An annual fee of __ and investigative fee of ___ shall be paid by each licensee.

(f) **Business Location**. Not more than one place of business shall be maintained under the same license, but the Commissioner may issue more than one license to the same licensee upon compliance with all the provisions of this Article governing issuance of a single license.

(g) **Other Business**. No licensee shall conduct the business of making loans under this Act within any office, suite, room or place of business in which any other business is solicited or engaged in unless, in the opinion of the Commissioner, such other business would not be contrary to the best interests of consumers and is authorized by the Commissioner in writing.

(h) **Revocation of License**. If the Commissioner shall find, after due notice and hearing, or opportunity for hearing that any licensee, or an officer, agent, employee or representative thereof, has violated any of the provisions of this Article, or has failed to comply with the rules, regulations, instructions or orders promulgated by the Commission, or has failed or refused to make its reports to the Commissioner, or has furnished false information to the Commissioner, the Commissioner may issue an order revoking or suspending the right of such licensee and such officer, agent, employee or representative to do business in this state as a licensee. No revocation, suspension, or surrender of any license shall relieve the licensee from civil or criminal liability for acts committed prior thereto.

(i) **List of Licensees; Complaint Process; Powers of the Commissioner**. The Commissioner shall maintain a list of licensees which shall be available to interested persons and the public. The Commissioner shall also establish a complaint process whereby an aggrieved consumer or any member of the public may file a complaint against

a licensee or non-licensee who violates any provision of this Act. The Commissioner shall hold hearings upon the request of a party to the complaint, make findings of fact, conclusions of law, issue cease and desist orders, refer the matter to the appropriate law enforcement agency for prosecution under this Act, and suspend or revoke a license granted under this Act. The all such proceedings shall be open to the public.

(j) **Regulations.** The Commissioner may promulgate regulations to carry out the provisions of this Act.

Section 5. INFORMATION AND ANNUAL REPORTS

(a) **Supervision by Commissioner.** Each licensee shall keep and use books, accounts, and records which will enable the Commissioner to determine if the licensee is complying with the provisions of the Act and maintain any other records as required by the Commissioner. The Commissioner, or designee, is authorized to examine such records at any reasonable time. All such records must be kept for four years following the last entry on a loan and according to generally accepted accounting procedures which means that an examiner must be able to review the recordkeeping and reconcile each consumer loan with documentation maintained in the consumer's loan file records.

(b) **Licensee Information.** Each licensee shall file an annual report with the Commissioner on or before the last day of March for the 12 month period in the preceding year on forms prescribed by the Commissioner. Such reports shall disclose in detail and under appropriate headings:

(1) the resources, assets, and liabilities of such licensee at the beginning and the end of the period.
(2) the income, expense, gain, loss, and a reconciliation of surplus or net worth with the balance sheets, and the ratios of the profits to the assets reported.
(3) the total number of deferred deposit loans made in the calendar year ending as of December 31st of the previous year.
(4) the total number of such loans outstanding as of December 31st of the previous year.
(5) the minimum, maximum, and average dollar amount of checks whose deposits were deferred in the calendar year ending as of December 31st of the previous year.
(6) the average annual percentage rate, the average number of days a deposit of a check is deferred during the calendar year ending as of December 31st of the previous year.
(7) the total number and dollar amount of returned checks, the total number and dollar amount of checks recovered, the total number and dollar amount of checks charged off during the calendar year ending as of December 31st of the previous year.
(8) verification that the licensee has not used the criminal process or caused the criminal process to be used in the collection of any deferred deposit loans or used any civil process to collect the payment of deferred payment loans not generally available to creditors to collect on loans in default during the calendar year ending as of December 31st of the previous year.

Such reports shall be verified by the oath or affirmation of the owner, manager, or president of the licensee.

(c) **Other Business.** If a licensee conducts another business or is affiliated with other licensees under this Act, or if any other situation exists under which allocations of expense are necessary, the licensee shall make such allocation according to appropriate and reasonable accounting principles as approved by the Commissioner. Information about other business conducted on the same premises as that of deferred deposit loans shall be provided as required by the Commissioner.

(d) **Annual Reports.** The Commissioner shall compile annual reports of deferred deposit lending in this state from the information provided under this Section and provide a copy to the Governor and the Legislature. Annual reports shall be available to interested parties and to the general public.

(e) **Copy of contract and Fee Schedule.** Each licensee shall file a copy of the contract described in Section 7(b) and the fee schedule described in Section 7(c) with the Commissioner prior to the date of commencement of business at each location, at the time any changes are made to the documents or schedule, and annually thereafter upon renewal of the license. These documents shall be available to interested parties and to the general public.

Section 6. REQUIRED ACTS.

(a) Each deferred deposit loan must have a minimum term of no less than two weeks for each $50 owed on the loan.

(b) A consumer shall be permitted to make partial payments (in amounts equal to no less than $5 increments) on the loan at any time, without charge.

(c) The maximum amount of the deferred deposit loan shall not exceed $300.

(d) After each payment made, in full or in part, on any loan, the licensee shall give to the person making such payment a signed, dated receipt showing the amount paid and the balance due on the loan.

(e) The minimum amount of a deferred deposit loan is $50.

(f) The check written by the consumer in a deferred deposit loan must be made payable to the licensee.

(g) Upon receipt of the check from the consumer for a deferred deposit loan, the licensee must immediately stamp the back of the check with an endorsement that states: "This check is being negotiated as part of a deferred deposit loan pursuant to [include the Code

citation to this Act] and any holder of this check takes it subject to all claims and defenses of the maker."

(h) Any facilitator, as defined in Section 2, is subject to enforcement under Sections 4 and the civil remedies provision of Section 10, if the person making the deferred deposit loans fails to comply with the requirements of this Act.

(i) The licensee must provide the consumer, or each consumer if there are more than one, with a copy of the loan documents described in Section 7 prior to the consummation of the loan.

(j) The holder or assignee of any check written by a consumer in connection with a deferred deposit loan takes the instrument subject to all claims and defenses of the consumer.

Section 7. REQUIRED DISCLOSURES.

(a) **Information Pamphlet Provided to All Consumers.** Before entering into a deferred deposit loan, the licensee shall deliver to the consumer a pamphlet prepared by or at the direction of the Commissioner which explains, in simple English and Spanish, all of the consumer's rights and responsibilities in a deferred deposit loan transaction, includes a toll free number to the Commissioner's office to handle concerns or complaints by consumers, and informs consumers that the Commissioner's office can provide information about whether a lender is licensed, whether complaints have been filed with the Commissioner, and the resolution of such complaints.

(b) **Loan Documents.** Licensees shall provide consumers with a written agreement on a form specified or approved by the Commissioner that can be kept by the consumer, and must include the following information in English and in the language in which the loan was negotiated:

(1) The name, address, phone number of the licensee making the deferred deposit loan, and the name and title of the individual employee who signs the agreement on behalf of the licensee;
(2) An itemization of the fees and interest charges to be paid by the consumer;
(3) Disclosures required by the federal Truth in Lending Act, regardless of whether the Truth in Lending Act applies to the particular deferred deposit loan.
(4) Disclosures required under any other state law;
(5) A clear description of the consumer's payment obligations under the loan.
(6) In a manner which is more conspicuous than the other information provided in the loan document and is in at least 14 point bold typeface, a statement that "you cannot be prosecuted in criminal court to collect this loan." Such notice shall be located immediately preceding the signature of the consumer.

(c) **Posting Requirements.** The following notices in English, Spanish, as well as other languages in which a significant amount of deferred deposit loan business is conducted, must be conspicuously posted by all licensees in each location of a business providing deferred deposit loans in at least 14 point bold typeface:

(1) That informs consumers that the licensee cannot use the criminal process against a consumer to collect any deferred deposit loan.

(2) The schedule of all interest and fees to be charged on such loans with an example of the amounts that would be charged on a $300 loan payable in 14 days and 30 days, giving the corresponding annual percentage rate.

(d) **Posting Requirements for Financial Institutions Not Governed by Section 8 on Permitted Fees.** Financial institutions making deferred deposit loans, which, because of the application of other state or federal law, are exempt from the fee limitations of this Act in Section 8, which charge fees, interest and charges greater than that authorized in Section 8 of this Act, must post, in a conspicuous place in the branch in which the deferred deposit loans are entered into, the notice below in at least 16 point bold typeface. A single instance of charging a consumer more than the fees, interest and other charges permitted in Section 8 requires the financial institution to post this notice.

"WARNING: The fees and interest charged on deferred deposit loans made at this institution are higher than those charged at other financial institutions."

Section 8. PERMITTED CHARGES

No licensee shall charge or receive, directly or indirectly, any interest, fees or charges except those specifically authorized by this Section.

(a) **Fees.** A licensee shall be permitted to charge no more than a $5 administrative fee for each deferred deposit loan entered into with a consumer.

(b) **Interest.** In addition to the service fee, the licensee shall be permitted to charge interest on the amount of cash delivered to the consumer in a deferred deposit loan in an equivalent no greater than 36% per annum (defined as a 365 day year). The rate charged on the outstanding balance after maturity shall not be greater than the rate charged during the loan term. Charges on loans shall be computed and paid only as a percentage of the unpaid principal balance or portion thereof. Principal balance means the balance due and owing exclusive of any interest, service or other loan-related charges.

(c) **Insufficient Fund Fee.** If there are insufficient funds to pay a check on the date of presentment, a licensee may charge a fee, not to exceed the lesser of $15 or the fee imposed upon the licensee by the financial institution. Only one such fee may be collected with respect to a particular check even if it has been redeposited and returned more than once. A fee charged pursuant to this subsection is a licensee's exclusive charge for late payment.

(d) **Rebates of Unearned Charges.** When a loan is repaid before its due date, unearned interest charges must be rebated to the consumer based on a method at least as favorable to the consumer as the actuarial method.

Section 9. PROHIBITED ACTS.

No licensee making deferred deposit loans shall commit, or have committed on behalf of the licensee, any of the following prohibited acts:

(a) Engaging in the business of deferred deposit lending unless the Commissioner has first issued a valid license.

(b) Threatening to use or using the criminal process in this or any other state to collect on the loan or any civil process to collect the payment of deferred payment loans not generally available to creditors to collect on loans in default.

(c) Altering the date or any other information on the check.

(d) Using any device or agreement which would have the effect of charging or collecting more fees, charges or interest than allowed by this Act, including but not limited to entering into a different type of transaction with the consumer.

(e) Engaging in unfair, deceptive, or fraudulent practices in the making or collecting of a deferred deposit loan.

(f) Entering into a deferred deposit loan with a consumer which is unconscionable. In determining whether a deferred deposit loan transaction is unconscionable, consideration shall be given to, but is not limited to, whether the amount of the loan exceeds 25% of the consumer's net income for the term of the loan.

(g) Charging to cash a check representing the proceeds of the deferred deposit loan.

(h) Using or attempting to use the check provided by the consumer in a deferred deposit loan as security for purposes of any state or federal law.

(i) Accepting payment of the deferred deposit loan through the proceeds of another deferred deposit loan provided by the same licensee or any affiliate.

(j) Making more than 1 deferred deposit loan to a consumer at a time.

(k) Making a deferred deposit loan, which when combined with another outstanding deferred deposit loan owed to another licensee, exceeds a total of $300 when combining the face amount of the checks written in connection with each loan. The licensee shall make inquiry of the consumer or utilize available information bases to determine whether such loans are outstanding. In no event, shall a licensee make a loan to a consumer who has two or more such loans outstanding, regardless of the total value of the loans.

(l) Renewing, repaying, refinancing, or consolidating a deferred deposit loan with the proceeds of another deferred deposit loan made by the same consumer. Upon termination

of a deferred deposit loan through the payment of the consumer's check by drawee bank, the return of a check to a consumer who redeems it for consideration, or any other method of termination, the licensee shall not enter into another deferred deposit loan with the same consumer for at least 30 days thereafter; provided, that a licensee may extend the term of the loan beyond the due date without charge.

(m) Accepting any collateral for a deferred deposit loan.

(n) Charging any interest, fees or charges other than those specifically authorized by this Act, including but not limited to:
(1) charges for insurance;
(2) attorneys fees or other collection costs.

(o) Threatening to take any action against a consumer that is prohibited by this Act, or making any misleading or deceptive statements regarding the deferred deposit loan or any consequences thereof.

(p) Making a misrepresentation of a material fact by an applicant in obtaining or attempting to obtain a license.

(q) Including any of the following provisions in loan documents required by Section 7(b):

(1) A hold harmless clause;
(2) A confession of judgment clause;
(3) A waiver of the right to a jury trial, if applicable, in any action brought by or against a consumer;
(4) A mandatory arbitration clause;
(5) Any assignment of or order for payment of wages or other compensation for services;
(6) A provision in which the consumer agrees not to assert any claim or defense arising out of the contract;
(7) A waiver of any provision of the Act.

(r) Selling any insurance of any kind whether or not sold in connection with the making or collecting of a deferred deposit loan.

Section 10. ENFORCEMENT

(a) **Civil.** The remedies provided herein are cumulative and apply to licensees and unlicensed persons to whom this Act applies and who failed to obtain a license:

(1) Any violation of any state law prohibiting unfair or deceptive trade practices constitutes a violation of this Act.
(2) Any violation of this Act constitutes a violation of any state law prohibiting unfair or deceptive trade practices.

(3) The violation of any provision of this Act, or regulation thereunder, except as the result of accidental or bona fide error of computation, renders the loan void, and the person shall have no right to collect, receive or retain any principal, interest, or other charges whatsoever with respect to the loan.

(4) Any person found to have violated this Act shall be liable to the consumer for actual, consequential, and punitive damages, plus statutory damages of $1000 for each violation (to be increased by the Commissioner to reflect inflation), plus costs, and attorneys fees.

(5) A consumer may sue for injunctive and other appropriate equitable relief to stop a any person from violating any provisions of this Act.

(6) The consumer may bring a class action suit to enforce this Act.

(7) The remedies provided in this section are not intended to be the exclusive remedies available to a consumer nor must the consumer exhaust any administrative remedies provided under this Act or any other applicable law.

(b) **Criminal**

Any person, including members, officers, and directors of the person who knowingly violates this act is guilty of a misdemeanor and, on conviction, is subject to a fine not exceeding $1,000 or is subject to imprisonment not exceeding 6 months, or both.

Section 11: SEVERABILITY

If any portion of this Act is determined to be invalid for any reason by a final nonappealable order of any court of this state or of a federal court of competent jurisdiction, then it shall be severed from this Act. All other provisions of this Act shall remain in full force and effect.

Appendix 2

THE FEDERAL SMALL LOANS ACT

The problem of providing small loans for the ordinary individual may be traced to the beginning of the twentieth century in North America when there was a "tremendous and insistent demand for small loans to wage earners: that the existing legal structure prohibited legitimate agencies from making such loans; that efforts to enforce repressive laws merely made the situation of the small borrower worse: and that the solution to the loan shark problem lay in creating agencies to make small loans at the lowest possible rate and in regulating the small loan business"[1]. This resulted ultimately in the Uniform Small Loans Law in the US.

In Canada the Federal Small Loans Act was enacted in 1939 partly as a response to concerns by the Federally incorporated loan companies that existing judicial interpretation did not permit them to make an adequate rate of return on loans. The Act established a graduated set of ceilings on interest rates on small loans up to $500, required all moneylenders who charged more than 1% per month to be licensed and regulated the terms of the loans in relation to such issues as refinancings. Each company was required to provide details of its loans to the Superintendent of Insurance who produced an annual report on the operation of the Act. Much of the debate on the original Act focused on the rate to be charged and opponents of the bill drew attention to the foundling credit union movement and urged that the banks lend to this segment of the market.

The rates established in 1939 permitted the companies to make a comfortable profit on small loans and in 1939 the public borrowed $10,000,000 from these institutions with the main uses being to pay property taxes, to pay mortgage and insurance costs and to buy fuel (see Waldron, *The Law of Interest in Canada* at 15.). The ceiling of $500 was raised to $1,500 in 1956 but by the late 1960s the interest rates had become unrealistic as had the ceiling of $1,500 which could be easily evaded by lending more than $1,500. From 1965 onwards the amounts lent declined significantly particularly at the lower end of the scale. By the mid 1970s most companies licensed under the Act experienced losses on their small loans. Moreover, credit unions, Causses Populaires and trust companies did not historically have to seek licences under the Act but by the 1970s were finding it necessary to seek licences under the Act.

The Small Loans Act could have been amended to update the rates and ceilings and indeed this was one proposal suggested within the Department of Consumer and Corporate Affairs in the late 1970s, which would have increased the level of loans to $5,000 and raised the interest rate ceiling. This was not regarded as acceptable by the Department of Finance and ultimately Bill C-44 was introduced by the Department of Finance in July 1980. It was supported by the finance companies, credit unions, banks and Caisses Populaires. The Act responded therefore to the demands of financial interests and probably also reflected the ideology that interest rates should be determined by market competition. The Department of Consumer and Corporate Affairs had wished to retain the Act because they believed that there was insufficient competition both in isolated areas of the country and for low income high risk consumers. The Bill introduced also

the criminal interest rate provisions of 60 percent which were a response to requests by the Montreal police for a method of controlling widespread loan sharking in that city.[2]

Bill C-44 had almost no public discussion and was rushed through both houses. Professor Ziegel criticized the abolition of the Act and argued that it was still necessary to protect lower income consumers and other rationed consumers.[3]

Given the proliferation of current forms of credit such as credit cards and lines of credit it would be more difficult to determine the scope of a current small loans law. There is also the issue of ensuring that the ceilings are adjusted periodically. An agency would be required to monitor and administer the Act. The principle underlying the Small Loans Act remains a valid important public policy objective, namely, the provision of small loans to lower income individuals at reasonable cost.

Notes:

1. See Rolf Nugent, "The Loan-Shark Problem" (1941) 8 *Law and Contemporary Problems* 3 at 6.

2. See generally Burns, *The Burrowers and Depositors Protection Act: A Case History in Legislative Failure* (MBA Thesis, UBC, 1981) which provides a fascinating story of the development of credit legislation in the 60s and 70s, including the repeal of the Small Loans Act).

3. See J. Ziegel, "Bill C-44 Repeal of the Small Loans Act and Enactment of a new Usury Law" (1981) 59 *Canadian Bar Review* 188.